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ABSTRACT

This handbook, written primarily to help faculty members with little prior experience in college or university budgeting, provides a self-help approach to basic budgetary matters. It describes the kinds of funds and other accounting terms found in college and university budgets as well as the accounting principles governing colleges and universities. There are also descriptions of the major components of an institution's income such as federal, state, and local appropriations (including formula funding), tuition grants and contracts, gifts, and sales and services of auxiliary enterprises such as institution-owned hospitals. It also considers factors in projecting future income such as demographics in relation to enrollments and such major components of an institution's expenditures as instruction, research, public service, academic support, student services, institutional support, operation and maintenance of physical plant, scholarships, auxiliary enterprises, and hospitals. The constraints of the typical budget are described such as personnel and other mandated expenses. The guide defines fiscal crisis, distinguishes fiscal crisis from a reallocation of funds, and details strategies for dealing with such crises. There is also a summary of sources for budgetary information about a given institution. Two appendices include an annotated bibliography of 10 items and the National Education Association Policy Statement on Part-Time, Temporary, and Non-Tenure Track Faculty Appointments. (Contains 26 reference notes.) (JLS)

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Budget Handbook for College Faculty and Staff

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Christine Maitland, Coordinator for Higher Education

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About the Author

Leroy W. Dubeck is professor of physics at Temple University in Philadelphia, Pennsylvania. He was chair of the Faculty Senate Budget Review Committee of Temple University and a faculty representative to the Business and Finance Committee of the Board of Trustees of Temple University. Dr. Dubeck was also chair of the Budget Priorities Committee of the College of Arts and Sciences of Temple University. He was national secretary-treasurer of the American Association of University Professors for four years and chaired that organization's Collective Bargaining Congress for two years. He was chief negotiator of the Temple University faculty union for nine years and was president of that organization for four years. He is co-author of *College and University Budgeting: An Introduction for Faculty and Academic Administrators* (Washington, D.C.: National Association of College and University Business Officers, 1984).

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Chapter 1. Introduction

George Lucas, the producer of *Star Wars*, made a telling point about budgets in *THX 1138*, his first feature-length science fiction film. The setting is an underground society controlled by computers and patrolled by robot guards. The hero makes a break for the outside, with the robots in hot pursuit. Then, just as the robots are about to overtake the hero, the computers order a halt. The cost of the chase has reached its budgetary limit.

As the budget determined the fate of the hero of *THX 1138*, so do the budgets of present day American colleges and universities determine the educational experience of both faculty and students. Faculty members are, for example, told that an academic project cannot be implemented because "It isn't in the budget." They are just as often given budgetary reasons for their salary increases, benefits, and support services. Yet many faculty are unaware of how to read or analyze a budget, despite the fact that every aspect of academic life is influenced by an institution's budget. What do these columns of numbers mean? What constitutes the entire budget of an institution? How can the financial health of an institution be determined? As educators, we know that ignorance is rarely bliss. It is certain disaster in budgetary matters.

This handbook, written primarily to help faculty members with little prior experience in college or university budgeting, provides a self-help approach to budgetary expertise rather than an exhaustive treatment of budgeting in higher education. Its purpose is to demystify institutional budgets for faculty members so that they will be able to focus on pertinent questions, locate the most useful information, and acquire experience in analyzing the budgets that exert control over so many facets of their academic life. In budgetary matters, as in other areas, knowledge is power. Administrators, although they can usually call upon the services of professionally trained financial staff to explain the budget, may also find this handbook useful.

Budgets serve several purposes. Since resources are always insufficient to satisfy the needs of all units in an institution, a budget serves as a mechanism for setting priorities among an institution's many activities. In addition, a budget summarizes the agreement between a given budget unit and the rest of the institution. That is, in exchange for a given level of funding in the budget, a department agrees to conduct a certain number of courses, advise students, and provide public service.

A budget also serves as a mechanism (or norm) for monitoring and controlling expenses. Thus when a department seeks to exceed the expenditures assigned to it in the budget, it has to justify the variation.

In addition, a budget serves as a mechanism for communication by informing the academic community of the priorities of the institution. As such, the budget reflects the outcome of a political process that may have many levels—from the legislature and the governor's office down through many levels of administration to the individual departments.

Chapter 2 of this handbook describes the kinds of funds and other accounting terms found in college and university budgets as well as the accounting principles governing college and university financial affairs. Note is made of the fact that faculty frequently confuse the current fund (or general fund or similarly titled fund) with the entire university budget, which consists of many funds. The four components of college and university financial statements which have been used through fiscal 1994-95 are: the balance sheet; statement of changes in fund balances; statement of current fund revenues, expenditures, and other changes; and footnotes. These are explained and illustrated for a fictitious institution, ABC University. In addition, the new financial statements required in the future for many institutions are described and illustrated.

Chapter 3 describes the major components of an institution's income such as federal, state, and local appropriations (including formula funding), tuition, grants and contracts, gifts, and sales and services of auxiliary enterprises (including institution owned hospitals). Also described are factors to consider in projecting future income, such as demographics in relation to enrollments.

Chapter 4 examines the major components of an institution's expenditures, including instruction, research, public service, academic support, student services, institutional support, operation and maintenance of physical plant, scholarships, auxiliary enterprises, and hospitals. Finding these categories in the budget, depreciation, and budget controls are also briefly discussed.

Chapter 5 describes the constraints and explores the flexibilities associated with typical college and university budgets. Personnel and non-personnel costs are examined as well as gifts/endowments, grants and contracts, research institutes and foundations, and reserve accumulation.

Chapter 6 defines a fiscal crisis and distinguishes between a real fiscal crisis and a reallocation of funds, which is an ongoing factor in all colleges and universities. Strategies used to meet fiscal crises are detailed. This chapter is recommended reading for faculty faced with inadequate salary increases or even retrenchment because of a proclaimed fiscal crisis.

Chapter 7 provides sources for budgetary information about a given institution. Since the quality of any budgetary analysis is dependent upon the available data, becoming informed about sources of appropriate data is important. These sources include appropriation bills, reports to state and government agencies (including the IRS) made by an institution, and reports from the U.S. Department of Education, the NEA Higher Education Research Center salary and budget reports, and the American Association of University Professors (AAUP) salary surveys.

There are two appendixes: an annotated bibliography and the NEA Policy Statement on Part-time, Temporary, and Non-tenure Track Faculty Appointments. All notes appear at the end of the book.

Chapter 2.
Fund Accounting

This chapter first looks at the accounting principles that govern the financial affairs of a college or university and the accounting terms used in conjunction with those principles, including those describing the kinds of funds found in college and university budgets. The principles and terms are then illustrated through our fictitious institution, ABC University.

PRINCIPLES AND TERMS

Most college and university accounting systems follow the principles summarized in *College and University Business Administration*, published by the National Association of College and University Business Officers (NACUBO). Some accounting practices differ from one institution to another, however, depending on such factors as whether or not the institution is public or private and whether the primary emphasis is on teaching or research.

The importance of understanding accounting principles and terms is demonstrated by the most common budgetary misunderstanding among faculty: the assumption that the current fund (or general fund or the like) represents the entire budget of the institution. Thus, when the current fund shows a deficit for a given year, faculty may assume that the institution is in difficult financial straits. That could indeed be the case; but it could also be the case that the institution is in excellent shape financially and that the deficit is the result of transfers of monies to other funds.

The following analogy makes this point clearer. Suppose that a friend has a checking account overdrawn by $2,000. In the absence of any other financial information, we might conclude that our friend is in serious financial difficulties. Suppose, however, that our friend has accounts in five other banks with an aggregate balance of $52,000. The $2,000 needed in the overdrawn account can be paid out from one of the other

accounts, leaving our friend with a tidy $50,000 in the bank rather than with serious financial difficulties.

Each of our friend's bank accounts is analogous to a different fund in an institution's budget. Thus we must examine the condition of all of the separate funds if we are to understand the true financial status of an institution.

The Accounting Equation

In the accounting equation, the difference between assets and liabilities indicates net worth or, as it is called in fund accounting, fund balance. Assets are economic values owned or under the control of an institution whose cost at the time of acquisition could be objectively measured. Assets generally are divided into two categories. The first consists of cash and that which can readily be converted into cash, such as investments and accounts receivable. The second represents costs incurred at an earlier date that have not yet been attributed to a given fiscal period, such as buildings, depreciable equipment, prepaid expenses, and deferred charges. Buildings and other long-lived assets of most higher education institutions have been subject to depreciation beginning with their 1990-91 fiscal year, due to regulations promulgated by the Financial Accounting Standards Board (FASB). FASB 93 is entitled Recognition of Depreciation by Not-for-Profit Organizations. Faculty need to be aware that prior to 1990-91 most institutions listed their assets at their original cost.

Liabilities are also divided into two categories. The first represents amounts that are owed to organizations or individuals outside the institution itself. Some of these liabilities must be paid immediately while others can be paid out over a period of many years. The second category of liabilities represents amounts that have been collected in cash by the institution (or whose collection is anticipated) but that have not yet been earned by the institution. Until this cash has been earned by the institution, it is carried as a liability to offset the fact that the cash itself is carried on the books as an asset. An example of this is tuition received by an institution in the spring semester for the following fall.

To reiterate, the accounting equation states that the institution's total assets minus its total liabilities equals its net worth. In fund accounting, assets minus liabilities equals the fund balance. Note that in fund accounting the term *funds* is used for a group of accounting entities, each of which has its own self-balancing set of accounts consisting of assets, liabilities, and a fund balance.

Types of Accounts

In fund accounting, *real accounts* are those used to record asset values, liability values, and net worth or fund balance values. These balances start with the inception of the organization and continue until the end of the organization or until the particular type of asset, liability, or net worth no longer exists. *Nominal accounts*, however, are those that expire at the end of a given fiscal period (usually a fiscal year) and are created anew at the beginning of the next fiscal year. These accounts are called income and expense accounts and are used to provide detailed information about income and expenses throughout the year.

Financial reports usually deal exclusively with real or nominal accounts. Note that an institution's net worth is changed by increases or decreases in both assets and liabilities, that is, by both income and expenses. Remember that the accounting equation means that the accounting system must always remain in balance. Thus any addition to assets by additional income must also appear as a combination of an increase in liabilities and/or net worth. The total of all assets must always equal the total of liabilities plus net worth.

Types of Resources/Funds

The following definitions are applicable to the financial statements of most institutions through their 1994-95 fiscal year. These definitions have been changed by FASB 116 and 117, to be discussed later. *Unrestricted funds* are resources that the institution may use for any purpose whatsoever. *Restricted funds* are resources that have external, legally binding restric-

tions placed upon their use. For example, a government grant (minus any indirect cost in the award, which can be treated as unrestricted revenue) can only be expended for the purpose for which it was awarded. Similarly, gifts sometimes carry legally binding stipulations restricting their usage.

Agency funds are assets that do not belong to an institution but rather are held by the institution on behalf of others.

Expendable funds are monies that can be spent by an institution. However, there may be restrictions on the purposes for which the funds can be spent. *Unexpendable funds* are monies that cannot be spent by the institution. For example, endowment funds cannot be spent. They must be invested and only the income can be spent. In many cases income from endowment funds is restricted income since it can only be spent for specified purposes. Student loan funds cannot be spent but must be loaned to students who will eventually repay them, when the funds will again be loaned to other students.

A governing board sometimes places surpluses from a given fiscal year (or part or all of unrestricted gifts) into a fund named the *quasi-endowment*. This is legally quite different than the regular endowment because the governing board is free to spend an institution's quasi-endowment in any manner it chooses (unless, for example, part or all of it is pledged as collateral for an institutional bank loan or bond offering). Thus, in accounting terms, an institution's quasi-endowment funds are unrestricted assets. Administrators of an institution may state that they cannot use these funds. This inability is because only the governing board can use the funds, although the board can release all the funds to the administration for use at any time.

Separate funds are created to account for financial activities related to a particular restricted donation, to a grant or contract, or to funds designated by the governing board for special purposes. The separateness of each fund insures that the restrictions placed upon the resources in each fund will be observed. However, for the purposes of efficient management and financial reporting, funds with similar restrictions or designations are often grouped together into what are termed f*und*

groups. Within each fund group we must distinguish between the unrestricted funds and the restricted funds. Accounting for each restricted fund balance separately is mandatory.

Accrual Accounting

Accrual-basis accounting is used in higher education. Here revenues are recognized *(booked)* when they are earned, and expenses are recognized when the goods and services have been used by an institution. This provides a much more accurate measure of an institution's financial status than cash-basis accounting, which recognizes income only when cash is received and similarly recognizes an expense only when cash is paid out by the institution.

Interfund Transfers

Transfers of funds between accounts occur quite frequently. Suppose, for example, that a physics department has a standing order with a supplier of liquid helium. A researcher in the department orders liquid helium for research sponsored by a government grant. The physics department pays the helium supplier out of departmental funds that are part of the institution's unrestricted current fund. The grant (which is treated as a separate fund) then transfers the amount of the purchase to the physics department's current fund account. The current fund is now in balance since the monies that it expended for the liquid helium have been repaid to it, and the grant fund is also in balance since the order of liquid helium has been charged to it, reducing its fund balance.

Chart of Accounts

Each institution has a chart of accounts that classifies each financial transaction according to the appropriate accounting principles and the reporting needs of the institution, both internal and external. Each account usually has both a descriptive name and a numerical or alpha-numerical designation to facilitate encoding.

FINANCIAL STATEMENTS OF ABC UNIVERSITY

The financial statements of a college or university normally have had four components for fiscal years prior to 1995-96: (1) a balance sheet, (2) a statement of changes in fund balances, (3) a statement of current fund revenues, expenditures, and other changes, and (4) footnotes (to the first three components). Examining sample fiscal documents in detail will help us to understand the relationship among them and to gain familiarity with fund accounting.

ABC University (our fictitious institution) offers a number of four-year degrees and has as well some masters' and doctoral programs. It receives federal research grants and also has a number of auxiliary enterprises such as student housing, a staff dining facility, parking lots, and an institutional press. It does not have a hospital, medical school, or physicians' practice plan. For simplicity, we also assume that ABC University does not have a life income fund (in which the donor specifies that the annual income from a gift is to be paid to an outside party for as long as that party shall live). The institution does not receive any appropriation from the local government.

ABC University also does not provide any post-retirement benefits other than pensions. Hence, its financial statements do not reflect as a liability the estimated cost of these benefits. FASB 106, Post Retirement Benefits Other Than Pensions, went into effect for fiscal years beginning after December 15, 1992. For most colleges this was their 1993-94 fiscal year. This requires the institution to reflect in its financial statements as a liability the actuarially determined cost of its post-retirement benefits other than pensions. Typically these benefits include health care, life insurance, and educational benefits for the children of retired faculty members and/or staff. Prior to this rule, the cost of these benefits were recorded as they were paid but no provisions for the future costs were made in the audited financial statements. The projected costs can be immense. For example, in 1993-94 the actual expenditure by one institution for such costs was $1,996,000. Yet the projected future cost associated with this was given in the institution's 1993-94 audited financial statements as $59,214,000. Some institutions

have eliminated or reduced these benefits, or required co-payments by employees, when faced with recognizing these large future obligations. It is difficult to accurately estimate the value of such obligations, since the cost is determined by such factors as the increase in cost of providing future health benefits twenty or thirty years from now, and the average retirement age of the institution's covered employees (the later they retire, the fewer the years for which retirement health benefits will be provided). These are obviously difficult to accurately determine; at best these numbers are educated guesses.

Current Fund Revenues, Expenditures, and Other Changes

Our analysis begins with an examination of Table 1, ABC University Statement of Current Fund Revenues, Expenditures, and Other Changes for the Year Ended June 30, 1995, for an important reason. This report, or a more detailed version of it, is often mistakenly referred to as the institution's budget. Our examination will indicate why this document alone does not provide a complete financial report on the institution.

The first part (part A) of Table 1 reports revenue for a single fiscal year (July 1, 1994, to June 30, 1995). The first column lists the categories of revenues or expenditures. The second column lists unrestricted revenues or expenditures, and the third column lists restricted revenues or expenditures. The fourth column is the total of the amounts in the second and third columns. For example, the category federal grants and contracts has $950,000 in unrestricted revenue and $3,650,000 in restricted revenue. The fourth column shows total revenue, $4,600,000. Under accounting rules the institution does not earn a current restricted fund, such as a federal grant or contract, until that fund is expended for the purposes for which it was restricted. In other words, revenue from restricted funds does not exist until these funds have been expended. Thus $3,650,000 of federal grants and contracts were expended by ABC University for the purposes specified in their awards during the 1994-95 fiscal year. The $950,000 in unrestricted federal grants and contracts represents the indirect cost recovery on the grants by the institution. The total of all current restricted

fund revenues equals the total of restricted expenditures and mandatory transfers, that is, $7,250,000. Mandatory transfers are amounts of cash that are transferred from the current fund into other funds. Usually the transfer is mandated by a debt instrument.

Table 1. ABC UNIVERSITY STATEMENT OF CURRENT FUND REVENUES, EXPENDITURES, AND OTHER CHANGES FOR THE YEAR ENDED JUNE 30, 1995

	June 30, 1995			June 30, 1994
A. REVENUES	**Unrestricted**	**Restricted**	**Total**	**Total**
Tuition and fees	$16,520,000		$16, 520,000	$15,430,000
State Appropriations	31,000,000		31,000,000	29,000,000
Grants and contracts				
Federal	950,000	$3,650,000	4,600,000	4,100,000
State	180,000	1,740,000	1,920,000	1,720,000
Local	20,000	150,000	170,000	160,000
Private gifts	350,000	1,430,000	1,780,000	1,650,000
Endowment income	230,000	280,000	510,000	490,000
Sales and services				
Educational activities	800,000		800,000	740,000
Auxiliary enterprises	8,850,000		8,850,000	8,450,000
Other sources	50,000		50,000	50,000
Total current revenues	$58,950,000	$7,250,000	$66,200,000	$61,790,000
B. EXPENDITURES AND MANDATORY TRANSFERS				
Educational and General Expenditures				
Instruction	$19,800,000	$1,540,000	$21,340,000	$20,100,000
Research	2,720,00	3,400,000	6,120,000	5,650,000
Public service	4,100,000	150,000	4,250,000	4,100,000
Academic support	3,900,000	60,000	3,960,000	3,800,000
Student services	2,800,000		2,800,000	2,600,000
Institutional support	5,100,000		5,100,000	4,800,000
Operation and maintenance of plant	5,220,000		5,220,000	4,900,000
Scholarships and fellowships	1,100,000	2,100,000	3,200,000	2,900,000
Total educational and general expenses	$44,740,000	$7,250,000	$51,990,000	$48,850,000
Mandatory transfers				
For principal and interest	650,000		650,000	550,000
For renewal and replacement	250,000		250,000	200,000
For loan fund matching grants	100,000		100,000	100,000
Total educational and general	$45,740,000	$7,250,000	$52,990,000	$49,700,000

Auxiliary Enterprises				
Expenditures	$ 8,600,000		$ 8,600,000	$ 8,200,00
Mandatory transfers				
For principal and interest	250,000		250,000	250,000
For renewals and replacements	100,000		100,000	100,000
Total auxiliary enterprises	$ 8,950,000	$ 0	$ 8,950,000	$ 8,550,000
Total expenditures and mandatory transfers	$54,690,000	$7,250,000	$61,940,000	$58,250,000

C. OTHER TRANSFERS AND ADDITIONS (DEDUCTIONS)

Excess restricted receipts over transfers to revenues		$ 350,000	$ 350,000	$ 250,000
Transfers to/from plant funds	$(1,500,000)	(20,000)	(1,520,000)	(800,000)
Transfers to/from endowment funds	(3,000,000)	(160,000)	(3,160,000)	(1,540,000)
Total transfers and additions (deductions)	$(4,500,000)	$170,000	$(4,330,000)	$(2,090,000)
Net increase in fund balance	$ (240,000)	$ 170,000	$ (70,000)	$ 1,450,000

Table 1 also presents the total of revenues and expenses by category for the prior fiscal year (July 1, 1993 to June 30, 1994), in the fifth column. This facilitates comparisons with the prior year's revenues and expenses and may help to identify significant changes in the financial status of the institution. On the revenue side, each income component (except the relatively insignificant "Other sources") has increased by several percent from the prior fiscal year. The increase in tuition and fees is due to an increase in tuition and fee rates and/or an increase in enrollment. There is nothing apparently unusual in the revenues part of Table 1.

The second part of Table 1 (part B) contains the expenditures and mandatory transfers. Here also there is nothing startling. Expenses in all categories have risen a few percent, perhaps because of inflation and compensation increases to employees. The educational and general expenditures increased from $48,850,000 in 1993-94 to $51,990,000, or about 6.4 percent.

The mandatory transfers for principal and interest, renewal and replacement, and loan funds will go into the restricted funds for which the transfers are made. In the cases illustrated, the transfers were probably required by debt instruments (which mandated the periodic setting aside of funds to pay principal and interest) and the need to accumulate certain reserves for renewal and replacement. The transfer to loan funds was probably mandated by a matching requirement in a federal student loan fund program. These transfers are required by factors over which the governing board does not have control. There are similar transfers mandated for the auxiliary enterprises. Incidentally, in considering auxiliary enterprises note that these enterprises lost money during each of the two fiscal years described in Table 1. In 1994-95, total revenue from auxiliaries was $8,850,000 and total expense was $8,950,000, for a net loss of $100,000. The loss in fiscal 1993-94 was also $100,000 (income of $8,450,000 and total expense of $8,550,000).

The third part of Table 1 (part C) presents other transfers. Transfers to plant funds from the unrestricted current fund were $1,500,000 in 1994-95, and the transfers to the endow-

ment funds were $3,000,000. Because of these transfers, which totaled $4,500,000, the change in fund balance for the unrestricted current fund was a negative $240,000. In other words the unrestricted current fund balance decreased by $240,000.

In evaluating the decrease of $240,000 in the unrestricted current fund balance over the fiscal year 1994-95, be sure to recognize that the nonmandatory transfers made at the discretion of the governing board from both restricted and unrestricted funds increased from $2,090,000 to $4, 330,000, or by over 100 percent! For 1993-94, the current unrestricted and restricted funds increased by $1,450,000. It is only because of the increase in nonmandatory transfers that these funds did not enjoy an even larger growth in fund balances in 1994-1995.

Clearly, the reasons for the increased transfers should be explored further. Was the $3,000,000 transferred to endowments placed in the institution's quasi-endowment fund over which the governing board has complete discretion? Why did the transfer to plant funds increase so dramatically? These questions demonstrate that Table 1 does not provide all the information needed to analyze the financial status of ABC University, but it does suggest some questions to ask. Table 1 also does not provide other crucial financial data. What are the total fund balances in the unrestricted current fund and in other funds? Also, to which funds precisely were the transfers made? To answer these questions we need information provided by the other types of financial statements, which we will consider next.

Before we do, however, note that there is a confusing item associated with restricted fund revenues. This item, the first one in part C, Table 1, shows excess restricted receipts over transfers to revenues in the amount of $350,000. This represents the difference between the $7,250,000 of restricted income (the last item in part A of Table 1) and the total of revenues from restricted funds in Table 2, column 2, of $8,750,000. This difference of $1,500,000 is then reduced by the indirect cost recovery transferred to the current fund as income for federal, state, and local grants and contracts that equals $950,000 + $180,000 + $20,000 = $1,150,000, as shown in Table 1, part A, in the second column, which lists unrestricted revenue. The difference between $1,500,000 and

$1,150,000—$350,000—is reported as excess of restricted receipts over transfers to revenues.

Changes in Fund Balances

Table 2. ABC University Statement of Changes in Fund Balances for the Fiscal Year Ended June 30, 1995, presents a summary of the changes in fund balances for all of the institution's funds during a given fiscal year. It also presents the fund balance for each fund at the end of the prior fiscal year, June 30, 1994, and at the end of the just completed fiscal year, June 30, 1995. For the unrestricted current fund, it presents essentially the same information as Table 1, but it does not provide as much detail.

In addition, the mandatory transfers that Table 1 separates into those for educational and general and those for auxiliary enterprises are here combined. For example, the total of $900,000 for mandatory principal and interest in Table 2 equals the sum of $650,000 and $250,000 for this category in Table 1. The total revenue to restricted funds of $8,750,000 in Table 2, part A, equals the amount in Table 1, part B, of $7,250,000 in restricted expenditures plus $1,150,000 in indirect cost revenue (listed under unrestricted revenues as $950,000 + $180,000 + $20,000, Table 1, part A), plus the $350,000 in excess receipts over transfers to revenues, Table 1, part C.

Table 2 also introduces a number of additional funds not described in Table 1. The loan funds in Table 2's column 3 are the monies maintained by the institution to assist students in completing their education. (The federal government has been a major provider of these monies.) The loan funds consist both of restricted funds from federal and private sources (and mandatory matching funds provided by the institution if that is required by the outside loan source) and of unrestricted funds transferred from the current unrestricted fund. When a loan is made from these funds, the asset classification changes from cash to loans receivable, but the fund balance is not affected. In order to see the distribution of loan fund assets we need to refer to Table 3, ABC University Balance Sheet for June 30, 1995, with Comparative Figures as of June 30, 1994.

The endowment and similar funds (Table 2, column 4) consist of truly restricted funds that may not be expended now (some of these funds may be expended after a stated event in the future, in which case these funds are sometimes called term endowments) and quasi-endowment funds whose use has been restricted solely by a resolution of the governing board. The truly restricted funds are simply referred to as the endowment; only the income from these funds may be used, and often even the uses of the income from endowment funds are restricted. By contrast both the principal and the income from quasi-endowment funds can be used at the discretion of the governing board unless these funds have been pledged to secure a loan or bond offering.

Endowment funds raise a knotty question, namely the distinction between principal and income. Usually the principal may not be used by the institution, whereas the income may be used. Questions such as whether a portion of the gain in market value of the assets in the endowment constitutes income are beyond the scope of this handbook and will be of importance only to institutions with substantial endowments.

Usually the assets of groups of funds are pooled. This means that normally no attempt is made to keep separate cash balances for each restricted fund. Rather each fund is assigned a number of shares in the portfolio of the entire fund group.

Plant funds (Table 2, columns 5 through 8) are normally subdivided into four subgroups: unexpended, renewals and replacement, retirement of indebtedness, and investment in plant.

Unexpended plant funds arise from restricted grants, gifts, and appropriations that can only be used for the acquisition of plant or major equipment. Governing boards sometimes also order a non mandatory transfer of unrestricted current funds into this fund category. These funds become unrestricted unexpended plant funds.

When monies are borrowed for acquisition of new plant and equipment, the monies are first accounted for in this fund subgroup. Later when the borrowed money is spent on plant and equipment, both the assets and liabilities are transferred to the investment in plant subgroup.

Table 2. ABC UNIVERSITY STATEMENT OF CHANGES IN FUND

	1	2
	Current Funds	
	Unrestricted	Restricted
A. REVENUES AND OTHER ADDITIONS	**$**	**$**
Unrestricted current fund revenues	58,950,000	
State grants and contracts—restricted		1,950,000
Federal grants and contracts—restricted		4,900,000
Local grants and contracts—restricted		180,000
Private gifts, grants, and contracts—restricted		1,430,000
Investment income—restricted		290,000
Realized gain on investment—unrestricted		
Realized gain on investment—restricted		
Expended for plant facilities		
Retirement of indebtedness		
Total revenues and other additions	58,950,000	8,750,000
B. EXPENDITURES AND OTHER DEDUCTIONS		
Educational and general expenditures	44,740,000	7,250,000
Auxiliary enterprise expenditures	8,600,000	
Indirect costs recovered		1,150,000
Loan cancellations and write-offs		
Administrative and collection costs		
Expended for plant facilities		
Retirement of indebtedness		
Interest on indebtedness		
Depreciation		
Total expenditures and other deductions	53,340,000	8,400,000
C. TRANSFERS AMONG FUNDS—ADDITIONS (DEDUCTIONS)		
Mandatory		
Principal and interest	(900,000)	
Renewal and replacement	(350,000)	
Loan Fund Matching	(100,000)	
Transfer to/from plant funds	(1,500,000)	(20,000)
Other transfers	(3,000,000)	(160,000)
Total transfers	(5,850,000)	(180,000)
Net increase (decrease) for the year	(240,000)	170,000
D. FUND BALANCE JULY 1, 1994	**1,740,000**	**1,500,000**
FUND BALANCE JULY 1, 1995	**1,500,000**	**1,670,000**

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BALANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1995

3	4	5	6	7	8
<--------			Plant Funds		-------->
Loan Funds	Endowment and Similar Funds	Unexpended	Renewals and Replacement	Retirement of Indebtedness	Investment in Plant
$	$	$	$	$	$
	60,000				
400,000	1,800,000	480,000	25,000	330,000	
80,000	300,000	20,000	30,000	50,000	
	150,000				
10,000	700,000	50,000	25,000	40,000	
					1,200,000
					3,000,000
490,000	2,950,000	610,000	80,000	420,000	4,200,000

110,000					
30,000					
		1,100,000	100,000		
				3,000,000	
				220,000	
					2,000,000
140,000		1,100,000	100,000	3,220,000	2,000,000

		(600,000)		1,500,000	
			350,000		
100,000					
				1,520,000	
150,000	3,010,000				
250,000	3,010,000	(600,000)	350,000	3,020,000	
600,000	5,960,000	(1,090,000)	330,000	220,000	2,200,000

7,650,000	**8,140,000**	**2,090,000**	**300,000**	**1,100,000**	**89,000,000**
8,250,000	**14,100,000**	**1,000,000**	**630,000**	**1,320,000**	**91,200,000**

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The renewals and replacement funds subgroup is used to acquire and expend monies to renew or replace assets currently in use.

Retirement of indebtedness funds are used both to pay the interest on outstanding debts of the institution and to repay the principal of the debt. As the debt is reduced, the equity in net assets will increase. This occurs because the liability for bonds (see Table 3, part G) will decrease in an amount equal to the reduction in debt, and there will thus be a corresponding increase in net investment in plant. This is illustrated in Table 2 by an expenditure of $3,000,000 in column 7, part B, retirement of indebtedness, and a corresponding revenue addition of $3,000,000 under investment in plant in column 8, part A.

The investment in plant funds subgroup reflects the assets and liabilities concerned with the institution's long-lived assets such as land, buildings, equipment, library books, and museum collections. Most of these assets are depreciated but not appraised to determine their current values. Thus the actual value of these assets today may be greater than the value for them reflected in these funds. The depreciation for 1994-95 was $2,000,000 and is listed in Table 2, part B, column 8. The fund balance of investment in plant is sometimes called net investment in plant. It is usually not classified as restricted or unrestricted because it is simply accounting for a set of net assets for which no further use is intended. Increases in net investments occur due to expenditures from the other three subgroups of plant funds as well as contributions in-kind such as buildings. In Table 2, part B, the unexpended fund had an expenditure of $1,100,000 and the renewals and replacement fund an expenditure of $100,000 for plant facilities. These might have funded repairs and renovations of buildings. The sum of these two amounts, $1,200,000, appears as a revenue under the investment in plant funds subgroup (part A) since expenditures of cash from the unexpended plant fund and renewals and replacement fund are recorded as an increase in investment in plant. Some investments in plant may be financed directly from the current fund. Typical examples are library books and some equipment items.

In examining Table 2, note that along any given row in

part C, Transfers Among Funds, the sum of the deductions from various fund groups, which are indicated by placing parentheses around the amounts deducted, must equal the sum of the additions to various fund groups. In short if money is transferred from one fund group it must be placed in another fund group. As an example, the line for mandatory transfers for principal and interest in part C contains two deductions ($900,000 in column 1 and $600,000 in column 5) and one addition ($1,500,000 in column 7) equaling the sum of the two deductions.

A deduction in a fund due to a transfer has the same effect as an expenditure. Both reduce the net increase in that category for the year. Thus, under unrestricted current fund (Table 2, part B, column 1), the total expenditures of $53,340,000 are added to the deductions of $5,850,000 (part C column 1) and this total of $59,190,000 is subtracted from the total revenues of $58,950,000, resulting in a net decrease in the unrestricted current fund of $240,000 (part C column 1) for the fiscal year in question. However, an addition by transfer to a fund acts like additional income. For example, a total of $250,000 was transferred into the loan funds (Table 2, column 3, part C), and that amount added to the revenues of $490,000 (column 3, part A) gives a total of $740,000 from which the expenditures of $140,000 are subtracted, leaving an increase in fund balance of $600,000 (column 3, part C).

To return to our analysis of the financial status of ABC University, Table 2 illustrates that in fiscal year 1994-95, $3,000,000 of the unrestricted current fund was transferred (part C) into the endowment fund group. Most probably (and this is conclusively confirmed by Table 3, as we will see) this money was transferred into the unrestricted quasi-endowment. In short, the governing board transferred part of the "surplus" from the current fund into an unrestricted endowment fund that could only be expended with the approval of the governing board.

A nonmandatory transfer of $1,500,000 was made from the unrestricted current fund (Table 2, column 1, part C) to the retirement of indebtedness fund, which then was used to retire the indebtedness faster than required by the loan instrument.

and, combined with the mandatory payment of principal and interest of $1,500,000 Column 7, part C), allowed the institution to retire $3,000,000 of indebtedness (column 8, part A). As Table 3 and Note B indicate, the institution completely repaid its mortgage. It finished the year with $1,320,000 in the retirement of indebtedness fund (Table 2, column 7, part C).

Balance Sheet

The reference just made to the outstanding indebtedness indicates that Tables 1 and 2 together do not present all of the information needed to assess the financial status of an institution. Thus, we next turn to our example of the third standard financial document as shown in Table 3, ABC University Balance Sheet for June 30, 1995, with Comparative Figures as of June 30, 1994.

The balance sheet contains all of the institution's assets, liabilities, and fund balances as of a certain date, usually the end of a fiscal year. The balance sheet also provides the value of these items at the end of the prior fiscal year. Consider first the unrestricted current funds (Table 3, part A). On June 30, 1995, the total assets were $2,850,000. This is equal to the total of $1,350,000 in liabilities (the total of the amounts listed next to accounts payable, accrued liabilities, students' deposits, due to other funds, and deferred credits) and the fund balance of $1,500,000. Table 3 gives greater details about the assets and liabilities in this (and every other fund group) than are found in Table 2.

Further amplification of some of the accounting terms used in Table 3 will assist our analysis.

- *Assets* are frequently listed at their historical cost minus depreciation. If the institution chooses to carry investments at market value, their values will change from reporting date to reporting date. All of the investments must be reported in the same manner, at historical cost or market value.
- *Accounts receivable* are usually listed as an amount net of probable losses due to doubtful accounts.
- *Inventories* are unexpired costs representing economic values that will have utility in the following year(s). They

include consumable supplies and supplies for resale, such as textbooks. Costs of these items must be determined on a consistent basis for all inventories using any of several accounting techniques (such as average cost).

• *Prepaid expenses* and deferred charges include such items as prepaid liability insurance.

Table 3. ABC UNIVERSITY BALANCE SHEET FOR JUNE 30,1995 WITH COMPARATIVE FIGURES AS OF JUNE 30, 1994

	June 30, 1995	June 30, 1994
A. CURRENT FUNDS		
ASSETS		
Unrestricted		
Cash	$500,000	$630,000
Investments	850,000	950,000
Accounts receivable, net	450,000	420,000
Inventories	800,000	750,000
Prepaid expenses and deferred charges	250,000	200,000
Total unrestricted	2,850,000	2,950,000
Restricted		
Cash	800,000	880,000
Investments	700,000	500,000
Accounts receivable, net	200,000	150,000
Unbilled charges	150,000	120,000
Total restricted	1,850,000	1,650.00
Total current fund	4,700,000	4,600,000
LIABILITIES AND FUND BALANCES		
Unrestricted		
Accounts Payable	500,000	560,000
Accrued liabilities	300,000	250,000
Students' deposits	250,000	200,000
Due to other funds	200,000	150,000
Deferred credits	100,000	50,000
Fund balances	**1,500,000**	**1,740,000**
Restricted		
Accounts payable	180,000	150,000
Fund balance	1,670,000	1,500,000
B. LOAN FUNDS		
ASSETS		
Cash	1,350,000	1,100,000
Investments	700,000	550,000
Loans receivable, net	6,000,000	5,850,000
Due from other funds	200,000	150,000
Total loan funds	**8,250,000**	**7,650,000**

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LIABILITIES AND FUND BALANCES

Fund balances		
U.S. Government grants refundable	6,000,000	6,000,000
University restricted	1,450,000	1,000,000
University unrestricted	800,000	650,000
Total loan funds	**8,250,000**	**7,650,000**

C. ENDOWMENT AND SIMILAR FUNDS

ASSETS		
Cash	2,100,000	140,000
Investments	12,000,000	8,000,000
Total endowment and similar funds	**14,100,000**	**8,140,000**

LIABILITIES AND FUND BALANCES

Fund Balances		
Endowment	8,750,000	6,050,000
Term endowment	1,100,000	1,000,000
Quasi-endowment		
Unrestricted	3,500,000	450,000
Restricted	750,000	640,000
Total endowment and similar funds	**14,100,000**	**8,140,000**

D. PLANT FUNDS UNEXPENDED

ASSETS		
Cash	600,000	800,000
Investments	700,000	1,590,000
Total unexpended	**1,300,000**	**2,390,000**

LIABILITIES AND FUND BALANCES

Accounts payable	100,000	100,000
Bond payable	200,000	200,000
Fund Balances		
Unrestricted	200,000	400,000
Restricted	800,000	1,690,000

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E. PLANT FUNDS RENEWAL AND REPLACEMENT

ASSETS		
Cash	150,000	100,000
Investments	480,000	200,000
Total renewal and replacement	**630,000**	**300,000**
LIABILITIES AND FUND BALANCES		
Fund balances		
Unrestricted	100,000	100,000
Restricted	530,000	200,000

F. PLANT FUNDS RETIREMENT OF INDEBTEDNESS

ASSETS		
Cash	320,000	100,000
Deposits with trustees (see note A)	1,000,000	1,000,000
Total retirement of indebtedness	**1,320,000**	**1,100,000**
LIABILITIES AND FUND BALANCES		
Fund balances		
Unrestricted	600,000	600,000
Restricted	720,000	500,000

G. PLANT FUNDS INVESTMENT IN PLANT

ASSETS		
Land and buildings	38,200,000	39,000,000
Land and buildings, state purchased	40,200,000	41,000,000
Equipment and library books	14,600,000	13,600,000
Equipment, state	3,800,000	4,000,000
Total investment in plant	**96,800,000**	**97,600,000**
LIABILITIES AND FUND BALANCES		
Notes payable	600,000	600,000
Bonds payable	5,000,000	5,000,000
Mortgages payable (see note B)	0	3,000,000
Net investment in plant	91,200,000	89,000,000

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• *Accounts payable* and *accrued liabilities* are amounts owed by the institution to those who have provided it with goods and services, but who have not yet been paid by the institution.

• *Student deposits* represent amounts that may be applied against future tuition or which might have to be, in part, refunded. These funds have not yet been earned by the institution.

• The *assets* and *liabilities* of the restricted current funds are similar to those in the unrestricted current funds.

• The plural term *fund balances* is used for the restricted funds since there is a separate fund for each source of restricted revenue.

• The *unrestricted current fund balance* represents some of the accumulated reserves from operations and can also be viewed as part of the working capital of the institution.

In concluding the analysis, note that the balance sheet for the loan funds (Table 3, part B) indicates three fund balances: one for the federal government loan grants and one each for the institution's unrestricted and restricted loan funds. In some states there might be a fourth line for state grants refundable.

In the case of endowments and similar funds (part C), the institution has increased its endowment, term endowment, and quasi-endowment by substantial amounts. The unrestricted quasi-endowment increased by $3,050,000, representing reserves at the disposal of the governing board.

In the plant funds, assets and liabilities are straightforward. In Table 3 we can see that under investment in plant, the net investment in plant (part G) increased because a $3,000,000 mortgage was repaid.

Thus the institution has significantly reduced its debt. In fact, ABC University is in excellent shape financially despite the fact that it experienced a decrease in its unrestricted current fund.

Finally, net investment in plant is not broken down into restricted or unrestricted because the assumption is that the resource in this category will remain there in perpetuity, that is, classroom buildings will not be sold to fund other purposes. Auditors' reports often list restricted, unrestricted, and investment in plant totals for all funds.

Footnotes

The fourth component of college and university financial statements is the footnotes to the first three components (balance sheet, statement of changes in fund balances, and statement of current fund revenues, expenditures, and other changes). Notes to ABC University Financial Statements list the significant financial policies of the institution's accounting system. In addition, there are notes further explaining certain matters. In the example, ABC University has placed $1,000,000 on deposit with trustees as partial security of a bond issue. This is frequently the case with bond issues. The trustees referred to here are usually banks or other financial institutions. The mortgage was repaid early, perhaps because of its relatively high interest rate (in comparison with that being paid on the bonds).

NOTES TO ABC UNIVERSITY FINANCIAL STATEMENTS

Summary of Significant Financial Policies

The financial statements of ABC University have been prepared on the accrual basis. The accounts of ABC University are maintained in accordance with the principles of fund accounting to reflect limitations and restrictions on the use of available resources. The accounts relating to specified activities or objectives have been classified into separate funds. Similar funds have been combined for financial reporting purposes.

Within each fund group, restricted resources are distinguished from unrestricted resources allocated for specific purposes by the board of trustees of ABC University. Restricted resources may be used only for the purposes established by the source of such funds.

Endowment funds are subject to restrictions of gift instruments requiring that the principal be invested in perpetuity and only the income be utilized. While amounts have been established by the board of trustees for the same purposes as endowment funds, any portion of such quasi-endowment may be expended at the board's discretion, subject to donor-imposed restrictions on use.

Investments are stated at cost.

Gains and losses arising from the disposition of assets are accounted for in the fund that owned such assets. Income from investments is accounted for in the fund owning them, except for income from investments of endowments and similar funds. This income is accounted for in the funds to which it is restricted or, if unrestricted, as revenue in the unrestricted current fund. Restricted current funds are reported as revenues and expenditures when expended for current operating purposes.

Inventories are stated at the lower of cost or market, cost being determined principally on the first-in, first-out method or by retail method in the university's bookstore.

Land, buildings, and equipment owned by ABC University are stated at cost minus accumulated depreciation. Land, buildings, and equipment owned by the State of .... that were constructed, purchased, or acquired for use by the university have been recorded in the university's records at the state's cost minus accumulated depreciation. To the extent that current university funds are used to finance plant assets, the amounts so provided are accounted for as (1) expenditures in the year of acquisition for new equipment, normal replacement, and renovations; (2) mandatory transfers for required debt amortization and interest; and (3) transfers of a nonmandatory nature for all other cases.

Note A. Deposits with Trustees

The university has on deposit with trustees the amount of $1,000,000 established for debt reserve and debt escrow funds for its bonds, which are due in 1998. As of June 30, 1995, the face value of the outstanding bonds was $5,000,000 at an interest rate of 4 percent. The bonds are secured by a pledge of gross revenues from the university as well as by the securities on deposit with trustees.

Note B.

The mortgage on certain university properties was repaid early during fiscal year 1994-95. The interest rate paid on the mortgage was 11 percent.

Sources of Budget Information

The best sources of financial information about an institution are in its annual audited financial statements. In those documents, external auditors confirm the amounts of the fund balances as well as their distribution among the above three categories.

Most colleges or universities produce audited financial statements annually. For the few that do not, it may be difficult or impossible to confirm the precise fund balances for that institution.

Unaudited operating budgets can often be misleading. They are estimates of financial plans for a forthcoming year and such estimates may, for example, underestimate income and overestimate expenses to portray a deficit that will not occur. One must have the actual **results** for a given year to know whether an institution ran a deficit or a surplus. Thus, in the analysis of institutional budgets, the most reliable information is always for budgetary years that are completed. The information about a current budget year always has greater uncertainty associated with it.

One may be able to estimate whether an administration deliberately budgets conservatively by comparing budgeted revenues and expenditures to actual revenues and expenditures over a number of years. If the institution consistently ends up performing better financially than budgeted, it is probably deliberately underestimating revenue, overestimating expenses, or doing both.

Recent Changes in Budget Formats and Definitions

The presentations of these financial statements are modified from time to time by new regulations promulgated by either the Financial Accounting Standards Board (FASB) or the Government Accounting Standards Board (GASB). Efforts have been made to keep the accounting rules the same for both organizations, but this has not always occurred. Some public institutions of higher learning follow GASB accounting rules rather than FASB accounting rules. The remainder of this chap-

ter presents the major accounting changes that have occurred since the publication of the first edition of the *NEA Budget Handbook for College Faculty and Staff* in 1989.

For fiscal years beginning after January 1, 1990, FASB 93, Recognition of Depreciation by Not-for-Profit Organizations, requires that institutions apply depreciation in their financial statements. This results in a large decrease in the value of Net Investment in Plant for the first fiscal year (usually 1990-91) in which depreciation is applied due to the effect of subtracting at one time the cumulative depreciation of all long lived assets since their purchase. For example, if buildings are depreciated over a 40 year period, a building that is 20 years old in 1990-91 would have half of its initial value "depreciated" that year. Until FASB 93 long lived assets were carried on the books at their original purchase price. The values listed for land, buildings and equipment in Table 3, Part G, are the depreciated values of those assets, i.e., depreciation has been applied to reduce their values below their initial cost.

The next major accounting change was FASB 106, Post Retirement Benefits Other Than Pensions, which went into effect for fiscal years beginning after December 15, 1992. For most colleges this was their 1993-94 fiscal year. This required the institution to reflect in its financial statements as a liability the actuarially determined cost of its post-retirement benefits other than pensions.

FASB 116 AND 117

Effective for fiscal years beginning after December 15, 1994, i.e. with the 1995-96 fiscal years of most not-for-profit institutions, there are two new FASB statements which must be applied. These are FASB 116, Accounting for Contributions, and FASB 117, Financial Statements of Not-For-Profit Organizations.

It should be noted that some articles refer to these statements as SFAS 116 and SFAS 117 (Statement of Financial Accounting Standards 116 and 117) while others have simply used FAS 116 and 117.

For many colleges and universities FASB 116 will have

only a minor impact. However, for some institutions the changes may be significant. At present colleges and universities record donations when they are received. Under FASB 116, institutions will be required to record contributions, *including pledges*, when received. Contributions must be unconditional, voluntary, and non-reciprocal. Contributions are defined as an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary non-reciprocal transfer by another agency acting as other than an owner.

At present, the expiration of restrictions on contributions is recognized when the money is spent. Under FASB 116, "A not-for profit shall recognize the expiration of donor-imposed restriction in the period in which the restriction expires, that is, when the stipulated purpose for which the resource was restricted has been fulfilled, when the stipulated time has elapsed, or when another stipulated event has occurred."

The result of the above changes is that the unrestricted assets of the institution will increase compared to the present system since some of the pledges are for unrestricted funds, and restrictions on other funds will be removed sooner for some contributions than at present. In addition, due to changes in definitions under FASB 117, contributions will be categorized as either unrestricted, temporarily restricted, or permanently restricted.

A further change due to FASB 116 is that the value of contributed services, which do not presently appear on most institutions' financial statements, must be recorded as contributions if they either created or enhanced non-financial assets or if they require skills that must be provided by specialists and which would typically be purchased if not provided as a donation. This change will further increase the value recorded for contributions.

Finally, under FASB 116, certain contributions of works of art would not have to be recorded as revenue as long as they meet the following criteria: held for public exhibition, education, or research in furtherance of public service rather then financial gain; protected, kept unencumbered, cared for and preserved; and subject to an organizational policy that requires

the proceeds from sales of collection items to be used to acquire other items for the collection.

Obviously, if a college or university has negligible contributions, these changes will have little effect on its "bottom line".

FASB 117 will have a much greater impact on the budgets of most colleges and universities. First, it changes the categories of assets. As indicated previously, the three categories at present are unrestricted, restricted, and net investment in plant. Under FASB 117, the definition of "unrestricted funds" changes to include "net investment in plant." This means that for fiscal years 1995-96 and beyond, colleges that adopt FASB 117 will report a new category: **New Unrestricted Fund Balance = Old Unrestricted Fund Balance + Net Investment in Plant.**

This will generally mean a huge increase in the Unrestricted Fund Balance as of June 30, 1996 compared to June 30, 1995—an increase that is simply the result of an accounting change. The auditor's Notes to the Financial Statements will no doubt reflect this accounting change. However it is the increase in the Unrestricted Fund Balance not due to its inclusion of Net Investment in Plant or of unrestricted pledges that is of greatest significance. That portion of the increase in Unrestricted Funds is in principle available for staff salaries and benefits or to avoid layoffs.

In addition to the new Unrestricted Funds, under FASB 117 there will be two categories of Restricted Funds.

Permanently Restricted Assets are those resulting from donor-imposed restrictions that these assets be maintained permanently. However, the institution may expend part or all of the income from these donated assets. The clearest example of permanently restricted assets is the historical value of true endowment funds. Changes occur in this class of assets from additional contributions, gains or losses on investment transactions if these gains must be retained permanently, income from investments if this must be added to the permanent endowment, or a transfer of endowment assets to another entity by judicial or similar authority. Basically, the permanently restricted assets are the true endowment funds.

The second category of restricted funds are *Temporarily Restricted Assets*, which also result from donor-imposed restrictions that permit the institution to only expend the donated assets as specified. These restrictions may be satisfied either by actions of the institution or the passage of time. Temporarily restricted assets may be restricted to support only a particular activity of the institution, may be required to be invested for a specified term ("term endowment"), or may only be used after some future date. Assets listed as Restricted under the current accounting rules will become Permanently Restricted funds if they are true endowments, while the remainder will become either Temporarily Restricted or Unrestricted under FASB 116 and 117.

There will also be new Financial Statements under FASB 117. First, there will be a Statement of Financial Position (Balance Sheet) which will replace the present Balance Sheet (by Funds). FASB 117 requires that this Statement, together with accompanying notes, provide the total amount of assets, liabilities, and net assets; the total amount of each class of net assets— unrestricted, temporarily restricted, or permanently restricted; information about restrictions on net assets; and information about liquidity. Information about liquidity may be provided in a number of ways. Assets and liabilities may be sequenced according to their nearness to cash. In this format, the most liquid assets would be stated first (cash and cash equivalents) followed by those that would convert to cash in the near future (such as accounts receivable) and finally by those that would not usually be converted to cash (such as property, equipment, and plant). Liabilities would be listed by nearness to maturity, starting with accounts payable and accrued expenses and ending with long term debt. The notes also normally contain other information about liquidity such as the annual maturity of long term debt over the next five years.

The institution has the option of preparing the Statement of Financial Position as a single column "corporate" model; as a set of columns, one for each class of net assets and a totals column; or as an operating/capital model which divides assets, liabilities, and each class of net assets between items used in ongoing operations and those retained for capital expenditures.

The drawback of the single column model is that the reader may be misled into thinking that the institution has more assets (i.e. those Net Assets listed as unrestricted) available for the operation of the institution than is actually the case, because most such assets may be Net Investment in Plant.

Table 4. ABC UNIVERSITY STATEMENT OF FINANCIAL POSITION

As of June 30	1995	1994
ASSETS	$	$
Cash	5,820,000	3,750,000
Accounts Receivable, Net	650,000	570,000
Unbilled Charges	150,000	120,000
Inventories	800,000	750,000
Prepaid Expenses	250,000	200,000
Investments	3,430,000	3,790,000
Loans Receivable, Net	6,000,000	5,850,000
Deposits With Trustees	1,000,000	1,000,000
Land, Building and Equipment	96,800,000	97,600,000
Long-Term Investments	12,000,000	8,000,000
Total Assets	**126,900,000**	**121,630,000**
Liabilities and Net Values		
Accounts Payable and Accrued	1,080,000	1,060,000
Short Term Notes Payable	600,000	600,000
Deferred Income and Credits	350,000	250,000
Long Term Debt	5,200,000	8,200,000
Total Liabilities	**7,230,000**	**10,110,000**
Net Assets		
Unrestricted	97,900,000	92,940,000
Temporarily Restricted	13,020,000	12,530,000
Permanently Restricted	8,750,000	6,050,000
Total Net Assets	**119,670,000**	**111,520,000**
Total Liabilities and Net Assets	**126,900,000**	**121,630,000**

One can compare Table 4 with Table 3 to see how the numbers in Table 4 were determined. For example, the "Accounts Receivable, Net" amount of $650,000 in Table 4 is the sum of $450,000 as "Accounts Receivable, Net" in Table 3, Part A, Unrestricted Assets plus the $200,000 from Table 3, Part A, Restricted Assets.

One can determine the "Unrestricted Net Assets" in Table 4 from Table 3 as follows:

Fund Balances as of	June 30, 1995	June 30, 1994
Current Funds Unrestricted	1,500,000	1,740,000
Loan Funds Unrestricted	800,000	650,000
Quasi-Endowment Funds	3,500,000	450,000
Plant Funds, Unexpended	200,000	400,000
Plant Funds, Renewal	100,000	100,000
Plant Funds, Retirement of Indebtedness	600,000	600,000
Plant Funds, Net Investment	91,200,000	89,000,000
TOTAL UNRESTRICTED	**97,900,000**	**92,940,000**

One determines the "Temporarily Restricted Net Assets" as follows:

Fund Balances as of	June 30, 1995	June 30, 1994
Current Funds	1,670,000	1,500,000
Loan Funds	7,450,000	7,000,000
Endowment	1,850,000	1,640,000
Plant Funds Unexpended	800,000	1,690,000
Plant Funds Renewal	530,000	200,000
Plant Funds Retirement Indebtedness	720,000	500,000
TOTAL RESTRICTED	**13,020,000**	**12,530,000**

The Permanently Restricted Funds are just the Endowment of $8,750,000 as of June 30, 1995 and 6,050,000 as of June 30, 1994.

The second financial statement required by FASB 117 is called a Statement of Activities (Income Statement). This replaces both the prior Statement of Current Fund Revenues, Expenditures and Other Changes (Table 1) and the Statement of Changes in Fund Balances (Table 2). FASB 117 identifies three possible formats for this statement. Format A is a single column of revenues, expenditures, and other changes for a

given fiscal year. Format B is a multi-column format of the same information, with a separate column for unrestricted, temporarily restricted, and permanently restricted funds, as well as a total. Format C is a two-statement approach. One statement would list unrestricted revenues, expenses and other changes in net assets while the second statement would list changes in net assets. Among the important changes that will be displayed in the Statement of Activities are that **all expenditures will be made out of the unrestricted funds, depreciation is a current expense,** and revenues are recorded in fund by type of restriction. Donor-restricted contributions that are met in the same reporting period that contributions are made may be reported as either unrestricted revenues or temporarily restricted revenues. FASB 117 requires the reporting of expenses by "functional classification" (i.e. instruction, research, etc.). Institutions of higher learning are encouraged, but not required, to also report expenses by "natural classification" (i.e. salaries, rent, etc.).

However, for one institution that is in the process of changing its financial statements to those required by FASB 117, I have seen small differences in the values of expenditures for many of the functional classifications between the old and new financial statements. Thus it may be difficult to construct Table 5 solely from the information presented in Tables 1 and 2. For example, additional information about the types of restrictions placed on gifts may be needed to divide them between Temporarily Restricted and Permanently Restricted revenues.

Even small differences for the values assigned to various expenditure categories will adversely affect the accuracy of a trend analysis over a period of several years for expenditures in each of the above categories. This kind of analysis can highlight, for example, a decrease in the relative percentage of expenditures going to instruction or an increase in administrative costs.

Table 5 represents a much simplified version of a Statement of Activities for ABC University. It does not include a comparison with the comparable totals for 1994, as would probably appear in an actual audited financial statement.

TABLE 5: ABC UNIVERSITY STATEMENT OF ACTIVITIES
For the year ended June 30, 1995

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
	$	$	$	$
Revenue Gains And Other Support				
Tuition and fees	16,520,000			16,520,000
State appropriation	31,000,000			31,000,000
Grants/Contracts				
Federal	950,000	3,950,000		4,900,000
State	180,000	1,830,000		2,010,000
Local	20,000	160,000		180,000
Private gifts	350,000	2,665,000	1,800,000	4,815,000
Investment income	230,000	470,000	300,000	1,000,000
Sales and Services				
Educational	800,000			800,000
Auxiliary	8,850,000			8,850,000
Realized gains in investments	150,000	225,000	600,000	975,000
Other sources	50,000			50,000
Total revenue/gains	59,100,000	9,300,000	2,700,000	71,100,000
Net assets released from restrictions	8,810,000	(8,810,000)		
Total revenue/gains and other	67,910,000	490,000	2,700,000	71,100,000
EXPENSES AND LOSSES				
Instruction	21,340,000			21,340,000
Research	6,120,000			6,120,000
Public service	4,250,000			4,250,000
Academic support	3,960,000			3,960,000
Student services	2,800,000			2,800,000
Institutional support	5,100,000			5,100,000
Operations/Maintenance	5,220,000			5,220,000
Scholarships	3,200,000			3,200,000
Auxiliary Activities	8,600,000			8,600,000
Interest	220,000			220,000
Loan cancel/collect	140,000			140,000
Depreciation	2,000,000			2,000,000
Total expenses	62,950,000			62,950,000
Change in net assets	4,960,000	490,000	2,700,000	8,150,000
Net assets start year	92,940,000	12,530,000	6,050,000	111,520,000
Net assets year end	97,900,000	13,020,000	8,750,000	119,670,000

Note that the changes in each class of net assets are the same from the Statement of Activities (Table 5) as from the Statement of Financial Position (Table 4).

The third required statement is a Statement of Cash Flow. This type of financial statement usually was not generated as part of the annual financial reports of colleges and universities in prior years. The purpose of this statement is to provide relevant information about the cash receipts and cash flow of the institution for a given fiscal year. The minimum requirements are that this statement provide: total changes in cash and cash equivalents; total amount of net cash provided by or used for investing activities, financing activities, and operations; interest paid on debt; significant noncash financing and investment activities; and a reconciliation of change in total net assets to net cash provided by or used by operations. There are two methods of presentation of cash flows. The Direct Method reports cash inflows and cash outflows by the major classes of specific activities. This approach would be far easier for a faculty member to understand since the cash received would be related to activities such as teaching or research.

The second method, called the Indirect Method, starts with net change in total assets for a given fiscal year (the bottom line of the Statement of Financial Position) and makes numerous adjustments to that number for the fiscal year to indirectly determine the cash flow. This cash flow number is the difference between the cash on hand as of the beginning and end of the fiscal year (the first line of the Statement of Financial Position).

Table 6 presents the cash flow figures for just one year of ABC University. Most Statements will include a second column to compare these with the corresponding numbers for the prior fiscal year.

The indirect method is easier for financial officers to prepare but much harder for faculty to understand. Since each of the financial statements that I have seen to date prepared under FASB 117 used the Indirect Method of determining cash flow, Table 6 depicts the Indirect Method.

Table 6. ABC UNIVERSITY STATEMENT OF CASH FLOWS (INDIRECT METHOD)

FOR THE YEAR ENDED JUNE 30, 1995	
Cash flows from operating activities	
Change in net assets	8,150,000
Adjustments to reconcile change in net assets to net cash provided by operating activities	
Depreciation	2,000,000
Increase in accounts receivable	(80,000)
Increase in unbilled charges	(30,000)
Increase in inventories	(50,000)
Increase in prepaid expenses	(50,000)
Increase in accounts payable	20,000
Increase in deferred income	100,000
Net cash provided by operating activities	1,910,000
Cash flows from investing activities	
Purchases of fixed assets	(1,200,000)
Increase in long-term investments	(4,000,000)
Decrease in short-term investments	360,000
Increase in loans receivable	(150,000)
Net cash used by investment activities	(4,990,000)
Cash flows from financing activities	
Repayment of long-term debt	(3,000,000)
Net cash provided by financing activities	(3,000,000)
Net increase in cash and cash equivalents	**2,070,000**
Cash and cash equivalents at beginning of year	3,750,000
Cash and cash equivalents at end of year	5,820,000

To understand whether a given adjustment should be negative or positive, one must consider whether an increase in the given asset or liability will increase or decrease the cash available. For example, depreciation, while it represents a negative against the overall net assets, does not use up any cash. Hence the institution should have the cash equal to depreciation. An increase in accounts payable means that the institution owes more money to vendors, etc, but it has the cash until these accounts are payed. The purchase of buildings and equipment is a negative for that amount of cash flow since the money is spent. An increase in accounts receivable is a negative entry in Table 6 since those funds have not yet been received. It should be noted that the net increase in cash of 2,070,000 from Table 6 is exactly the increase in cash given in the first line of Table 4.

It should be noted that this represents an oversimplified version of the indirect method of cash flows. Real examples may contain such confusing items as "amortization on the discounts of investments."

Finally the new statements will also contain Notes to the Financial Statements, similar to the Notes for Tables 1-3.

In summary, the new financial statements mandated by FASB117 may be harder to understand and less useful to faculty and staff if the administration adopts certain options in preparing them. Faculty and staff will need to request that administrations keep these statements "user-friendly" if they are to be meaningful to the academic community in the future.

TO SUM UP

This chapter's brief introduction to fund accounting makes it possible to read financial statements that are more complicated than those of ABC University. Remember that financial statements are rarely exactly alike. Experience in working with an institution's statements is needed to understand all of the details.

Chapter 3.
Analysis and Projection of Income

The major sources of income for institutions of higher education include tuition and fees, appropriations (federal, state, and local), grants and contracts, gifts, endowment, and sales and services (of such auxiliary enterprises as hospitals). These sources are quantified in Table 7, Revenues for Public and Private Colleges and Universities, and discussed in this chapter. Included in the discussion are factors faculty need to consider in projecting income components into the future.

Note that the percentages listed in Table 7 are for the entire revenues received by all public and private colleges and universities. Only one year (1985-86) is included in the table because the percentage of total revenues for each income component has varied only slightly from year to year and the relative importance of each component varies substantially among institutions. It may be helpful to plot the percentage for each revenue component for a given institution over a number of years in order to identify trends in revenue.

STATE APPROPRIATIONS

State appropriations are the largest income source for most public institutions, representing 43.2 percent of total income, but are of negligible importance to most private institutions representing only 0.9 percent of total income.

State appropriations to institutions of higher education are made in a number of states using a formula. Some of these states use formulas to appropriate funds, others only to review the adequacy of funding. In states using formulas to appropriate funds, the components of the formulas need to be examined to determine the relative impact on revenue of a variety of factors. However, even in those states where a formula determines the overall appropriation for an institution, the components of the formula usually do not determine how an institution spends its appropriation. For example, if an institu-

tion receives $1,000,000 by formula for maintenance, that exact amount need not necessarily be spent on maintenance.

The rather complex appropriations formula adopted (and fully funded) by the Tennessee legislature for its 1988-89 fiscal year for higher education provides a useful example of formula funding. The formula, which has been refined for over a decade, contains the following components:

1. **Instruction and Academic Support**
   A. The formula recommends funds based upon faculty salaries and student/faculty ratios at comparable institutions. These comparable institutions are a group of 10 peer institutions selected for each of four Tennessee institutional groups based upon size, program mix, and other factors. (See Chapter 4 for a fuller discussion of peer institutions.) Average faculty salaries are computed for the peer institutions using national salary data. The funding calculation then divides the projected student credit hour estimation by the student faculty ratios to determine the number of instructional personnel required; and this number is multiplied by the average salary factor of the predetermined peer institutions. Adjustments are then made for graduate teaching assistants, equipment, and clerical support, and to recognize enrollment fluctuations among terms.

Table 7. REVENUES OF PUBLIC AND PRIVATE COLLEGES AND UNIVERSITIES, 1985-86

A. PUBLIC INSTITUTIONS	Total Amount	Percent of Total
Tuition and fees	$9,439,177,000	14.5%
Appropriations		
Federal	1,401,367,000	2.2
State	28,071,070,000	43.2
Local	2,150,459,000	3.3
Government grants and contracts		
Federal	5,451,003,000	8.4
State	1,149,516,000	1.8
Local	175,385,000	0.2
Private gifts, grants and contracts	2,109,782,000	3.2
Endowment income	398,603,000	0.6
Sales and services		
Educational	1,596,946,000	2.5
Auxiliary	6,684,794,000	10.3
Hospitals	4,708,930,000	7.2
Other	1,667,600,000	2.6
Total current fund	65,004,632,000	100.0%
B. PRIVATE INSTITUTIONS		
Tuition and fees	13,677,429,000	38.6%
Appropriations		
Federal	216,143,000	0.6
State	331,219,000	0.9
Local	2,701,000	0.0
Government grants and contracts		
Federal	5,636,237,000	15.9
State	359,695,000	1.0
Local	215,961,000	0.6
Private gifts, grants, and contracts	3,301,124,000	9.3
Endowment income	1,877,295,000	5.3
Sales and services		
Educational	776,548,000	2.2
Auxiliary	3,989,342,000	11.3
Hospitals	3,517,705,000	9.9
Other	1,531,586,000	4.3
Total current Fund	35,432,985,000	100.0%

Source: Center for Statistics, U.S. Department of Education

B. A funding factor for library needs is then calculated per full-time equivalent (FTE) student. This factor varies with the type of institution.
C. Expenditures for other instructional support is then built into the formula as a percentage of the instructional expense by type of institution.

2. Maintenance and Operation of Physical Plant

The formula recognizes that the maintenance and operation of the physical plant costs 12 percent of the total institutional expenses. This charge is distributed over each square foot of education and general space, resulting in a rate of $1.90 per square foot plus $0.19 per square foot constructed prior to 1960 and not renovated since then.

3. Institutional Support

The formula recognizes that institutional support accounts for 12 percent of total expenditures and assigns $125,000 plus 10.55 percent of the first $12,000,000 of educational and general expenditures plus 7.55 percent of the amount over $12,000,000.

4. Student Services

Expenditures for student services, including admissions and records, financial aid, student health, and athletics, are 10 percent of total expenditures. The formula rate is $144 per headcount student plus $144 for FTE student, where 15 undergraduate credit hours or 12 graduate credit hours per semester constitutes one FTE student.

5. Research

The research function comprises 1 percent of total expenditures. Funds are allocated based upon the institution's historical expenditures for research and its ability to attract sponsored research funds.

6. Public Service

Each institution receives $35,000 plus 1 percent of instructional costs for the administration of public services.

7. College Preparatory Programs

College preparatory programs are recognized in the formula by a specific credit hour rate multiplied by the number of hours taught at each eligible institution over the past calendar year.

8. Staff Benefits

Staff benefits are analyzed in relation to previous annual expenditures. Fluctuations in benefit costs are considered in making recommendations for the subsequent year.

9. Student Aid

Requests for student aid funds are analyzed in relation to previous annual expenditures.

10. Special Allocation

Institutions may request funds for specific projects that cannot be adequately addressed through regular allocations.

11. Desegregation

Institutions may request funds for desegregation purposes that cannot be adequately addressed through other formula components.

12. Performance Funding

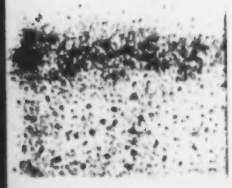
The formula provides a sum up to 5 percent of appropriations to recognize and reward efforts to evaluate and improve instruction.

13. Equipment Replacement Supplement

The formula includes an amount equal to 5 percent of equipment investment at each campus as of June 30, 1987, to supplement equipment budgets.

14. Longevity

The formula includes an amount for longevity pay to reward state employees for each year of service beyond three years.



15. Inflation

The formula includes inflation factors for utilities, non-salary expenditures, and library acquisitions.

Note that several factors in this formula depend directly or indirectly on projections of student enrollments. Because an anticipated decrease in student enrollment could lead to a decrease in the funds appropriated under this formula, Tennessee "cushions" institutions against such a decrease in appropriations by regulations that supplement the formula. Note also that this formula uses the salaries paid at a predetermined set of comparable institutions to determine the salary per faculty member (in instruction and academic support factor 1A). This approach builds in cost-of-living increases for faculty since faculty salaries at comparable institutions increase with inflation. Other funding formulas, however, relate this instruction and academic support cost factor only to the salaries paid at the institution to which the formula is being applied. Because of such wide variation in formula details from state to state, we must study each specific formula in use in order to project the impact of enrollment and other changes on the state appropriation for a given institution.

In many states, capital appropriations are legislatively separated from ongoing operations appropriations. Normally, an institution's administration submits an ordered list of requests for such capital projects as new buildings, major renovations, and teaching or research equipment. Then, depending upon available funds, some or none of the highest priority items may be funded in a given year.

Calculating the precise impact of enrollment changes on an institution's appropriation based on overall increases or decreases in enrollments may be difficult. For example, an increase in 80 students at the master's level in physical sciences might justify an increased funding of 10 faculty members in the physical sciences while an increase of 80 physical science students in freshman courses might justify an increased appropriation for only 4 faculty. In fact, for a formula as sophisticated as Tennessee's, without access to enrollment projections by instructional level and discipline it is probably impossible for a

faculty member to calculate precisely the impact on an institution's state appropriation of an overall increase or decrease in FTE students.

For many states, however, appropriations are not determined by formula. In order to project the probable state appropriation for a given institution in those states—and even in the formula funding states—we need to have extensive knowledge of the state's economy and its political processes. One guideline to use in estimating the future is looking at the immediate past. For example, if an institution has received a 5 percent increase in its state appropriation in each of the past four years, it is likely to receive a 5 percent increase next year. But extrapolating from past data provides no certain guide. The overall economy of the state may change for worse—or better. If the state anticipates increased revenues, it is generally much easier to obtain a greater increase in an institution's appropriation than the recent past indicates. But the state's economy is only half the story. Relative future funding priorities within the revenues available to the legislature and the governor need to be anticipated.

College and university administrations normally have full- or part-time lobbyists whose duties include providing the institution's president and governing board with up-to-date information on funding probabilities and, of course, trying to influence these probabilities in favor of the given institution. An institution's president often spends a significant amount of time talking with legislators and state officials when appropriations are passing through the legislative process. A faculty member or faculty committee normally never has access to comparable information. This means that faculty must either rely on the estimates given them by their administration on state funding probabilities for the future, or they must belong to a faculty organization that has its own lobbyists in the state capitol. There is no substitute for inside political intelligence in projecting future state funding.

FEDERAL APPROPRIATIONS

The federal government makes certain appropriations to public and independent institutions, such as land-grant aid, educational equity programs, and categorical support for college libraries. As Table 7 shows, the aggregate of these appropriations amounts to only 2.2 percent of the total revenue in 1985-86 for public institutions and only 0.6 percent for private institutions. With the deficit reduction efforts being undertaken in Washington, D.C. in 1995, these appropriations may decrease in the future.

LOCAL APPROPRIATIONS

In some cases, particularly for community colleges, local governments provide direct appropriations to an institution. This appropriation may be tied to the state appropriation. For example, one state requires the county government to provide one third of the total revenue for a community college located within its boundaries while the state provides an equal appropriation for each such community college. Another state permits a portion of local property taxes to be levied expressly for the benefit of its community colleges.

TUITION AND FEES

As Table 7 indicates, tuition and fees are the second largest source of funds for public institutions and the largest source of funds for private institutions of higher education. Unlike most prices, tuition represents only a portion of the cost incurred in providing instructional services to students. Many factors are considered in setting tuition rates, including the tuition at peer institutions, student financial aid needs, the general state of the economy, the philosophy of the institution or the state system and, last but not least, the need to balance the budget.

The setting of tuition rates can be critically important to the enrollment level and to the types of students that faculty find in their classrooms. Higher tuition rates generally mean that fewer students seek admission. Furthermore, higher

tuition rates dramatically reduce the availability of higher education to students in certain economic strata. Such institutions as the Ivy League universities may not need to be concerned when they reduce demand by substantially raising tuition rates because they have a surplus of well-qualified applicants. But colleges and universities with a more regional audience are much more restricted in setting tuition levels if they wish to maintain or increase enrollment levels. In the public sector, enrollment levels may affect their state appropriations. Furthermore, in the public sector, an agency of the state may have to approve tuition increases or increases may be tied to the state's appropriation to the institution. For example, in Tennessee, student fees are to be set at a level equal to 30 to 32 percent of state appropriations for universities and 24 to 26 percent of state appropriations for two-year colleges.

In the area of student aid, the tuition level has an impact on expenditures. Institutions with a strong commitment to student aid must plan to increase their own aid expenditures to parallel the increase in tuition so as not to price themselves out of reach of a substantial number of their traditional students. Also, an institution's own student aid becomes more important if the federal government is threatening to reduce its aid.

The federal government funds a number of student grant and loan programs. These programs fund part or all of the tuition of several million students annually. Some of these programs provide funds to the institutions, which distribute them to student applicants, and other programs provide funds directly to the students. Some states also provide student tuition grants or loans.

A major concern in estimating future revenues is understanding the demographics of the region from which a given institution draws the great majority of its students. Out of the 50 states, 41 predict an increase in the number of high school graduates between 1991-92 and 2001-02. According to the 1994 *NEA Almanac of Higher Education* (page 91), California and five other states expect growth of more than 40 percent in this rough indicator of demand for admission to higher education institutions.

GOVERNMENT GRANTS AND CONTRACTS

Federal, state, and local governments award grants and contracts to colleges and universities, usually on a competitive basis. These funds may be crucially important to institutions with a major commitment to research and other sponsored projects. There are two cost components to most grants and contracts: direct costs and indirect costs. Funds to cover direct costs can only be expended for the purpose stated in the grant application. But funds to cover indirect costs can be added to the general revenue of an institution and expended in any manner, providing financial flexibility.

The classification of particular costs as direct or indirect depends in some cases upon how an institution is structured to conduct research and other sponsored activities. Direct costs are those that may be readily identified as belonging to a given project, such as salaries and benefits of those working on the project, supplies and equipment for the project, and travel to carry out the project. Secretarial costs and computer charges can appear as direct costs if these are charged to the grant account for services rendered, or they can be treated as centrally administered services without charge backs and thus be part of indirect costs. Typically, administrative and purchasing support, libraries, office supplies, maintenance, and janitorial services are treated as indirect costs.

Colleges and universities determine their indirect cost rates using guidelines prepared by the federal government. These guidelines also provide the methodology to calculate the fringe benefit rates to be applied to the salaries of employees working on sponsored research. The rates are reviewed by federal auditors to determine that they are in agreement with the guidelines prepared by the Office of Management and Budget.

Institutions normally apply the same indirect cost rates to state, local, and private grants as to federal awards. However, some private foundations have policies that do not permit any payments for indirect costs. In these cases the indirect costs become, in essence, an institutional contribution to the research similar to its contribution of faculty release time.

Private colleges and universities generally budget indirect cost reimbursements as unrestricted income. Public institutions in some states have to turn all such funds over to the state. In other states the institutions may retain some or all overhead cost reimbursement as unrestricted income.

The projection of direct and indirect cost revenues from grants and contracts involves knowledge of who is responsible for obtaining an institution's current grants. If several key research-oriented faculty leave an institution, their grants will probably leave with them. Usually the largest grants are received by medical school researchers from such sources as the National Institutes of Health and the National Science Foundation. Grants are sensitive to the funds appropriated to major funding sources. For example, the National Science Foundation's budget can substantially affect the level of grant funding at many research oriented institutions.

PRIVATE GIFTS, GRANTS, AND CONTRACTS

As already noted, private grants and contracts are usually treated like federal grants and contracts with respect to indirect cost reimbursement. Gifts are recorded as unrestricted or restricted. Unrestricted gifts may be spent for any purpose by an institution and hence are another source of financial flexibility. Restricted gifts are limited by the donors to be used only for specified purposes. However, if these purposes are high on the priority list of institutional activities, these restricted funds may be substituted for general institutional funds, thereby freeing the latter funds for other uses.

Increases in fundraising efforts generally take both time and money. Increased staffing for a development office means increased investment, and that investment may take one to three years to produce substantial increases in gift income. Since the most difficult funds to raise are unrestricted gifts, institutions often establish a development plan that presents high-priority institutional projects to possible contributors, thereby enhancing restricted gifts that can be used to replace unrestricted institutional funds.

ENDOWMENT INCOME

The endowment income is substantial for only a small number of institutions. As Table 7 indicates, endowment income is much more important for private institutions than for public colleges. The endowment income is also dependent upon the types of investments made with endowment funds and the returns on these investments.

SALES AND SERVICES OF EDUCATIONAL AND AUXILIARY ACTIVITIES

Sales and services of educational activities include non-credit workshops, testing services, a physicians' practice plan, and a college theater. Auxiliary activities include residence and dining halls, intercollegiate athletics, a bookstore, a university press, a university-owned faculty club, and university-owned parking facilities. Normally these auxiliary enterprises are supposed to break even or show a profit. Some of them, such as intercollegiate athletics and university presses, often run a deficit. In such cases a determination must be made as to whether or not the magnitude of the deficit is justified by the indirect benefits the institution may receive from the activity.

HOSPITALS

Although the overall income from hospitals was only 7.2 percent of the overall revenue for all public colleges and universities in 1985-86, those institutions that do own a hospital find that it probably accounts for a quarter or more of total revenue. If the institution in addition has a medical school and thus a physicians' practice plan, these three related operations—hospital, medical school, and physicians' practice plan—may together account for 40 to 50 percent of the entire income of the institution. In these cases the entire institution either prospers or suffers financially depending upon the fortunes of these major operations.

Hospitals have been faced with concerted efforts by federal and state governments to contain the rising costs of medical

services. The federal government developed a set of so-called diagnostic related groups (DRGs) to which a given illness or treatment could be assigned. The government then assigned a given dollar payment for each patient treated for each such DRG. This has resulted in hospitals not being fully reimbursed for their costs in providing some health services. The patient "mix" between Medicare, Medicaid, Blue Shield, and other private health insurance carriers is crucial to the financial viability of a hospital. Occupancy rates and discharge rates are also critically important. A hospital typically seeks to have all of its beds filled but at the same time wants the patient stays (for those on Medicare and Medicaid for whom the payment will be a fixed dollar amount no matter how long they stay) to be as short as is warranted medically. For university hospitals that provide free or only partially reimbursed care for the indigent, institutions sometimes are subsidized by the city in which the hospital is located.

Chapter 4.
Analysis and Projection of Expenditures

This chapter examines the major components of an institution's expenditures, including instruction, research, public service, academic support, student services, institutional support, physical plant operation and maintenance, scholarships, auxiliary enterprises, and hospitals. Also described are factors faculty need to consider in projecting expenditure components into the future.

Table 8, Expenditures of Public and Private Colleges and Universities, 1985-86, provides an overview of the expenditures for American colleges and universities. As for income components, only one year is included in the table because the percentage of total expenditures for each component has varied only slightly from year to year. Note that there are few substantial differences between public and private expenditures. The greatest difference is that instructional costs are larger in public institutions (34.6% against 26.6% in private institutions) while expenditures for scholarships are notably larger in private institutions (7.5% against 2.5% in public institutions).

EXPENDITURE COMPONENTS

Before considering each expenditure line in detail, we need to define a *cost*. Information about cost is accumulated in accounting records and summarized periodically in the financial reports of the institution. To understand these financial reports, we need to be aware of certain accounting concepts. The most important of these is determining when to recognize that a financial event has transpired and thereby should be reported in the financial statement. In cash basis accounting, financial events involving either the receipt or the expenditure of cash are the only events recognized in the accounts. Under this system, expenditure accounts report only those entries for

which cash has been disbursed. Such cash-basis accounting has a major shortcoming since the institution may owe a great deal of money but simply not have paid its bills.

Accrual-basis accounting overcomes this difficulty by recognizing financial events when an obligation to a second party is incurred or when a claim against the second party is legally established. At these times the financial event is recorded in the appropriate account. Many weeks or even months may pass before the event produces a change in cash to or from the institution. Virtually all institutions of higher education operate on accrual-basis accounting, and expenditures are reflected when obligations to outside parties are incurred rather than when cash is paid to these parties.

Table 8. EXPENDITURES OF PUBLIC AND PRIVATE COLLEGES AND UNIVERSITIES, 1985-86

	Total Amount	Percent of Total
A. PUBLIC INSTITUTIONS		
Instruction	$21,880,782,000	34.6%
Research	5,705,144,000	9.0
Public service	2,515,734,000	4.0
Libraries	1,685,052,000	2.7
Other academic support	3,008,491,000	4.7
Student services	2,921,758,000	4.6
Institutional support	5,667,144,000	9.0
Plant operation	5,177,254,000	8.2
Scholarship/fellowships	1,575,909,000	2.5
Mandatory transfers	735,695,000	1.2
Auxiliary enterprises	6,830,235,000	10.8
Hospitals	5,358,699,000	8.5
Other	131,956,000	0.2
Total current fund	**63,193,853,000**	**100.0%**
B. PRIVATE INSTITUTIONS		
Instruction	$9,151,318,000	26.6
Research	2,732,222,000	8.0
Public service	603,799,000	1.8
Libraries	866,279,000	2.5
Other academic support	1,107,570,000	3.2
Student services	1,641,180,000	4.8
Institutional support	3,683,642,000	10.7
Plant operation	2,427,972,000	7.1
Scholarships/fellowships	2,584,266,000	7.5
Mandatory transfers	456,754,000	1.3
Auxiliary enterprises	3,698,067,000	10.8
Hospitals	3,333,414,000	9.7
Other	2,055,405,000	6.0
Total current fund	**34,341,889,000**	**100.0%**

Source: Center for Statistics, U.S. Department of Education

Instruction

The accurate determination of instruction costs has been a major goal of financial analysis in higher education institutions for some time. These instruction costs can then be used to compare different departments within a college or different colleges within a university for cost effectiveness. In theory different institutions can also be compared by this procedure.

There are a number of ways to perform cost analysis. The three tiered approach involving a five-step procedure described here is recommended by the National Association of College and University Business Officers in its *Cost Accounting Handbook for Colleges and Universities* (Washington, D.C., 1983). The approach assumes the existence of an institutional cost accounting system that can provide a database over a period of years. Comprehensive cost analysis assigns costs to *cost centers* for later attribution to cost objectives. In the instructional area, cost centers can be defined as departments, schools, or colleges, although in principle the term could be applied to individual faculty or even individual courses. The most frequently used cost objectives are those listed in the expenditures column in Table 8.

In the three-tiered approach, first tier costs are all those that are readily identifiable with a given cost center. For the instruction portion of the budget, they include salaries and fringe benefits, supplies and services, travel, contractual services, and non-capital equipment. In some institutions they also include the costs of computing support for instruction programs.

Second tier costs consist of all first tier costs plus indirect costs that are attributable to a given cost center. Indirect costs consist of the costs of services that support instruction and may include such costs as those for plant maintenance, computing facilities, accounting services, libraries, and general administration. Because several competing allocation schemes are available, administrators are more likely to be in agreement on the distribution of direct costs than on a methodology for distributing indirect costs.

Third tier costs include all second tier charges plus a depreciation charge on facilities and capital equipment. (Depreciation charges are discussed in a later section of this chapter.)

The procedure for cost accounting is to (1) designate specific cost centers, (2) choose appropriate cost categories, (3) assign all first tier costs to the selected cost centers and categories, (4) assign all second tier and third tier costs to these selected cost centers and categories, and (5) calculate unit costs.

The unit costs selected for instruction are usually semester credit hour (SCH) or full-time equivalent student (FTE). These costs vary with the level of instruction provided. The cost per SCH is lowest for lower division undergraduate courses, more for upper division undergraduate instruction, and greatest for graduate, professional, and doctoral level instruction. In order to project future instruction costs we need to know the details of future enrollments. From the estimated distributions of students by categories, we can determine the needed number of full-time faculty by using historical student-faculty ratios for each level of SCH. Then we multiply the number of needed faculty by the appropriate average faculty salary to determine the overall faculty salary budget. There are pitfalls in determining future instructional costs by this approach. One is that we must know the future salaries of the faculty who will teach these courses, and these may depend upon collective bargaining agreements not yet concluded or upon an appropriation not yet made by the state. Another is that we must predict the costs of fringe benefits. The growth in cost of a number of medical fringe benefits has outstripped inflation for many years. Although it is difficult to project cost increases for medical coverage years into the future, we can predict that as the average age of college faculty increases, the costs of medical, dental, and life insurance benefits are going to rise substantially based upon an institution's experience in the use of each benefit.

Some fringe benefit costs are more easily projected. For example, Social Security payments are made at a preset rate up to a preset maximum salary. This means that if we know

future staff salaries, we can calculate future Social Security costs because the existing statute gives these rates and the maximum payments for years to come.

In analyzing instruction costs it is important for us to distinguish between *average cost* and *marginal cost* per student. If we divide the total instructional costs by the number of FTE students, the result is an average cost per FTE, which normally is substantially larger than the marginal cost per FTE, that is, the cost of providing instruction to an additional student.

Most of the second tier costs are relatively fixed and do not vary with the number of students. Even first tier costs may not vary with a small increase or decrease in students. A given lecture course may need one instructor whether there are 25, 30, or 35 students enrolled. For such a course an increase or decrease of five students may have no impact on the cost of instruction. Thus the marginal cost of five more students in that one course would be zero, rather than the average cost per FTE.

When student enrollments are increasing annually, a state appropriation formula based on average costs per student will probably provide incremental funding that exceeds incremental costs. The institution may use these "extra" dollars anywhere in its budget. Conversely, should enrollments fall, thereby decreasing the state appropriation by formula, the decrease in funding is likely to exceed the decrease in incremental costs. This may require the institution to undertake additional cost cutting. Some states are trying to cushion public institutions against budgetary cutbacks due to small variations in enrollments.

Comparisons are often made between "peer" institutions by state agencies or others on a number of variables, including the cost per SCH or FTE student. An institution whose cost per SCH or FTE is low may be praised by state officials for efficiency and even rewarded by additional appropriations. Thus, knowing the factors that were used in determining the cost per SCH is important. Were the costs only first tier costs or were they second tier costs? Does each institution being compared treat the costs the same? We must determine if some institutions treated the second tier costs, and even the first tier costs, differently.

An even more fundamental question is involved in comparing educational statistics between institutions: which institutions are truly comparable? The method for determining comparison groups is sometimes influenced by the issue(s) to be considered. Among these issues are faculty salaries and benefits, tuition rates charged, room and board charges, student-faculty ratios, administrator-faculty ratios, class sizes, degrees awarded by field and level, and cost per SCH. Brinkman and Krakower define four types of comparison groups: competitor, peer, aspiration, and jurisdictional.[1]

A competitor group consists of institutions competing with one another for students, faculty, and/or research. For example, suppose that an institution identifies a comparison group solely on the basis of competition for faculty. If these institutions are compared only with respect to faculty salaries and benefits, the comparison group may withstand scrutiny even if some of the comparison institutions are quite different on other grounds and the comparison group inappropriate for other purposes.

A peer group consists of institutions with similar missions and scope. We never find exact matches, however, and it is a matter of judgment as to what constitutes a sufficient match.

An aspiration group consists of institutions that are different from the home institution but are worthy of emulation by it. When a comparison group contains many institutions that are clearly superior to the home institution, it is probably an aspiration comparison. Problems arise when peer groups are confused with aspiration groups, particularly if the confusion is noted by individuals in the political arena outside of the institution since it raises serious credibility questions concerning any comparisons that are made.

A jurisdictional group consists of institutions belonging to the same political or legal jurisdiction, normally a state. The reason for this grouping is obvious: state officials want to compare the institutions (particularly in the public domain) that are being supported with public funds. Whether or not the comparisons are valid depends upon the issue(s) being compared.

Institutional classifications established to facilitate national reporting represent another basis for comparing colleges and universities. Among the classifications that are used are those of the National Center for Education Statistics, the American Association of University Professors (for reporting faculty salaries), the National Center for Higher Education Management Systems, and the Carnegie Commission on Higher Education.

The importance of selecting the proper comparison group for a given issue cannot be overemphasized because the institutions selected may well predetermine the outcome of the comparison. For example, in the collective bargaining arena the faculty representative may demonstrate, based on the faculty-selected comparison group, that the faculty are underpaid, while the administration's negotiating team may see from the comparison group it has selected that faculty are overpaid! In some cases, arbitrators or even the courts have had to select comparable institutions for faculty compensation issues.

A major issue in the comparison of instruction costs between institutions is the use of part-time faculty. They are generally paid less per course than full-time faculty and enjoy far fewer fringe benefits. Consequently, two institutions with markedly different fractions of teaching conducted by part-timers are likely to have markedly different unit instruction costs. Chapter 5 examines the use of part-time faculty in more detail.

Research

Research includes all activities organized specifically to produce a research outcome. The amount listed for research in Table 8 is from current fund revenues only. Sponsored grant accounts will transfer some funds into the current fund in the form of charges for indirect costs; the remainder of the funds in these restricted fund accounts must be expended for the activities specified in the grant or contract proposal.

Comparing the amount of indirect costs assigned as revenue to the unrestricted current fund with the amount of expenditures from that fund for research is informative. Table

1 in Chapter 2 indicates that for ABC University $1,150,000 in indirect costs were received by the institution from federal, state, and local grants and contracts while $2,720,000 was expended upon research from unrestricted current funds. Some expenditures of restricted research funds can substitute for unrestricted fund expenditures. For example, if a grant pays part of the academic year salary of a faculty member, this portion of the salary is not assigned to current fund unrestricted expenditures.

Public Service

Public service includes all activities conducted primarily to provide noninstructional services for individuals and groups external to the institution. These activities include workshops and seminars, free legal service from a law school, community recreation services, and broadcasting services.

Libraries

This component (sometimes contained within academic support) includes the costs of operating all of the libraries in an institution. Some institutions budget all such costs centrally, but others may separate out a law school or medical school library that are then budgeted under the corresponding college budgets. In recent years, the increase in the costs of books and periodicals has far outstripped the general cost-of-living increases. Since some publications come from abroad, foreign exchange rates also affect the funds needed to purchase these books and periodicals. In order to review an institution's library resources over time, compare the increases in its book and periodicals budget to the increases in the average cost of these items over time. Faculty may find that their library, like many others, has had to reduce its purchases because of the escalation of book and periodical costs. Many libraries are turning to computerized services that allow on-line searches for materials which are then mailed or faxed to the student or faculty member.

Other Academic Support

Academic support includes all institutional operations that provide support services to the basic missions of teaching, research, and public service. In some institutions, as already noted, the library system is part of this component instead of being treated separately. Among expenditures in this area are those for academic administration, academic computer operations, audiovisual services, course and curriculum development, and personnel development.

Student Services

Student services include all institutional operations that enhance students' intellectual, cultural, emotional, and physical well-being outside the classroom. Among these are academic advising, career counseling, student admissions, student records, financial aid, student health services, and some student activities. Other student activities, such as intercollegiate athletics, are normally treated as auxiliary enterprises and are discussed under that section.

Institutional Support

Institutional support includes all institutional operations that provide support for day-to-day operations, excluding physical plant operations and maintenance. Encompassed are the fiscal departments of the institution (such as the comptroller's office and accounts payable), the purchasing department, the executive officers of the institution and their office staffs, public relations, the development office, and institutional charges such as liability insurance. According to a Department of Education study (*Insight*, Feb. 8, 1988, p. 24) 20 cents of every dollar spent by colleges and universities in 1984-85 was used to cover administrative costs. By comparison, this figure was 17.7 cents 10 years earlier. The same study showed that the number of nonteaching professionals had risen to 23.2 percent of all institutional staffing, up from 19.4 percent in the mid-1970s. At the same time, the number of faculty on staff had

fallen from 32.2 to 30.8 percent. One reason for this growth in nonteaching professionals may be the growth in counseling, financial aid, and other student support programs. Nonetheless, examining the size of the administration at a given institution over a number of years may prove informative, although this is often difficult to accomplish because college administrative staffs may have their compensation reported, at least in part, under the instruction, research, or public service categories.

Plant Operation and Maintenance

Plant operation and maintenance include all institution operations involving the physical plant, except for those expenses allocated to auxiliary enterprises or to a university-owned hospital. Among these are custodial service, repairs and maintenance, property insurance, rents paid, utilities, and debt service. This expenditure is most likely to involve many other funds (generally referred to as physical plant funds) in addition to costs listed under the current fund. There are usually interfund transfers for physical plant expenditures, including debt service.

Expenditures for utilities are sometimes difficult to predict exactly since the weather (a very cold winter or very hot summer) can substantially alter them from an average value for prior years. In addition, the opening of any new building always increases overall institutional utility costs (unless an older, less energy efficient building is closed).

Scholarships and Fellowships

Scholarships and fellowships normally include only the institutional funds that are expended for scholarship aid and for trainee stipends at both the undergraduate and graduate levels. Federal or state scholarship or loan funds that are distributed by an institution are usually placed in a restricted fund and disbursed directly from that fund to the students (or to the institution's current fund in the form of tuition income).

Auxiliary Enterprises

Auxiliary enterprises are entities that furnish services directly to faculty, staff, and students, and that receive fees for these services. Such services may include parking, dining facilities, dormitories, student stores, a university press, and intercollegiate athletics. Physical plant charges are normally assigned to each auxiliary enterprise. The goal is generally to have each auxiliary activity at least break even financially, but this does not always happen. Funds assigned to auxiliary enterprises sometime act as discretionary funds for the administration.

Perhaps the auxiliary enterprise that has attracted more faculty attention than any other is intercollegiate athletics. Football and basketball coaches are often paid more than an institution's president. Millions are sometimes spent on sports stadiums that are used only a small fraction of the year, and star coaches and athletes often get far more of the publicity generated about an institution than do its best faculty. Among justifications offered for large athletic expenditures are that (1) athletics make money for the institution, (2) athletics generate a great deal of publicity about an institution which in turn attracts students, and (3) athletics attract donors to the institution. Let us examine each of these points in turn.

The National College Athletic Association carried out a survey in 1985[2] that found that only 1% of the reporting institutions listed the financial goal of their athletic program as earning money to support the rest of the institution. If the remaining 99% do not have this as the financial goal of their athletic program, it seems clear that few institutions receive net income from athletics. Thus, when an institution does make money on a sports program, the tendency is to expend the profits on more sports. Losses, on the other hand, are funded by the rest of the university.

The claim that the fame of a successful sports program attracts more students, from a wider geographic area, is probably true but difficult to quantify. A student may select an insti-

tution for many reasons, only one of which is its having a successful sports program. Furthermore, the success of a sports program is more likely to appeal to a male applicant. Even student surveys are not likely to provide conclusive proof for the claim or to provide any quantitative data to compare with the subsidy that the athletic program may require.

The assertion that a successful sports program attracts more donors is also probably true, but these donors, interested in sports, will probably earmark their contributions solely for the sports programs.

In conclusion, it is important to note that many institutions charge students an "activity fee" or "athletic fee," which is then assigned as income mainly to intercollegiate athletics. In essence, this "income" reduces what would otherwise be a larger deficit for the athletic operations. Put another way, if there were no separate athletic fees even more athletic programs would need a subsidy from tuition or other institutional funds. Note that the expenditure of these funds often benefits male students much more than female students.

Hospitals

As indicated in Chapter 3, university hospitals are hard pressed to break even. There are often conflicts in assigning costs between a hospital and a related medical school and physicians' practice plan. Note that an examination of the costs of a hospital discloses the existence of a cost, depreciation, they are able to pass back to third party payers as a part of the daily room charge. Consequently, a hospital may record many millions of dollars per year of depreciation on its physical plant and equipment but be reimbursed for all of this cost. This is a different cost from others in that dollars for depreciation, unlike dollars budgeted for salaries, are not necessarily spent by the institution in the budget year in which they are received. Rather, they can be set aside to replace equipment and buildings, or even be used for other purposes (although there may be constraints placed on the use of these funds by, for example, the federal or state government).

FINDING THESE COMPONENTS IN THE BUDGET

In examining the current fund budget of your institution, you may not find some of the components or categories listed. Normally there will be a summary budget page with expenses listed by categories nearly identical to those in Table 8. The pages of budgetary detail following the summary page may be arranged, for example, by institutional officer. A provost or vice president for academic affairs might supervise units that contribute to teaching, research, public service, and academic support. A college's budget may simply state an overall budget and not break it down by the expense categories in Table 8. If you are serving on a faculty budget committee, you may wish to ask for the individual budget components that contributed to the overall expenditure categories in Table 8. Requesting that each college's or even each department's budget be broken down into its individual cost components will allow you to identify the fraction of a college budget that is allocated to teaching or research, for example, and then to compare this to the fraction at other "comparable" colleges, either internal or external to the university. This comparison can provide objective data to assess the commitment to teaching or research of your institution.

DEPRECIATION

The effective date of Statement of Financial Accounting Standard No. 93, Recognition of Depreciation for Not-For-Profit Organizations, was for the budget year starting after January 1, 1990.

Not-for-profit organizations must recognize the cost of using up the future economic benefits or service potentials of their long lived tangible assets (*depreciation*) and must disclose the following:

a. Depreciation expense for the period.
b. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date.
c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date.

d. A general description of the method or methods used in computing depreciation for major classes of depreciable assets.

Under FASB 117, depreciation will be treated as a current fund expense, beginning with the 1995-96 fiscal year. What impact will depreciation have under FASB 117? Let us speculate, for the implementation of FASB 117 on depreciation in colleges and universities may indeed have far-reaching effects on all of higher education.

Consider, for example, the present dilemma facing many institutions of not having the funds to replace antiquated buildings and equipment. How did this situation come about? For years administrators did not set aside adequate funds for renovations and replacements. Legislatures did not approve funds for these purposes because they were not embedded in the budget. Put another way, if a legislator or trustee saw that a given institution was operating *with a balanced budget* what was there to worry about? Few of them realized that the balanced budget was misleading because it did not take depreciation into account. In that sense, the budget system itself may have contributed to the outcome of antiquated physical plants with inadequate reserves to replace them.

The impact of depreciation may therefore be to demonstrate to all that institutions do not have balanced budgets unless they have set aside funds for depreciation. This in turn may either be a financial blessing or a disaster. If, for example, a legislature appropriates additional funds to an institution to cover the cost of depreciation, many institutions, for the first time, will have adequate funds to modernize their facilities. But if the state orders administrators to set aside part of their current appropriations for this purpose without augmenting these funds, institutions may be left with no way of balancing their budgets except by resorting to measures usually associated with a fiscal crisis.

There will be other effects of depreciation. Since the demonstrable cost of providing instructional or research services will rise substantially, the charges for these services in the form of tuition and fees and the indirect cost rates for sponsored research may also rise dramatically.

BUDGET CONTROLS

The institution's budget sets allocations for each budget unit or cost center. Adequate controls are needed to insure that expenditures do not exceed allocations. Usually one or more institutional budget office is given the responsibility to monitor the expenditures of each unit and to bring overspending of budgets to the attention of the appropriate institutional officials. In addition, it is the primary responsibility of each budget unit head to monitor that unit's budget.

"Position control" is sometimes a part of budget controls. In some institutions, departments are able to use the funds budgeted for unfilled positions for other purposes. In other institutions, any vacant position has its funds withdrawn immediately from the department. At state supported institutions, the savings from vacant positions may revert to the state.

Institutions normally use budget reports as a way of implementing budgetary controls. These budget reports are normally made at least monthly and compare budgeted amounts to those actually spent by each budget unit during the preceding month and cumulatively from the beginning of the current budget year. Comparisons to the prior year are also sometimes included.

Modern computerized budget systems allow budget heads to see the status of their budgets on the computer screen as of a given moment in time. They instantly reflect the cost of any purchase order. If these systems are tied into payroll, a budget unit head may no longer be able to hire someone without the prior approval of superiors because the financial system will not permit the printing of a payroll check for the individual. In short, these computerized systems provide stronger central control over all budgets.

Budget revisions often occur during a budget cycle. The changes are caused either by changes in income from the amounts budgeted or changes in expenditures. Small changes can usually be accommodated without revising the budget. Many institutions have a contingency expenditure line included in the budget, and unforeseen expenses can be paid from

this line without requiring the modification of other budget lines. Similarly, if the shortfall in revenue is small, this line can be used to make up for the revenue shortfall by simply not spending part or all of the funds assigned to "contingency." Sometimes the unforeseen expenditures and/or revenue shortfall are too large to be paid for by this line: and in that case many parts of the institution's budget may have to be modified. Budget reductions made in the middle of an academic year may be particularly painful since much of the institution's costs may be set for the year. This matter is discussed further in the next chapter on constraints in the budget.

Chapter 5. Constraints and Flexibilities In the Budget

This chapter examines the constraints that exist in typical college and university budgets and thus also looks at the flexibilities that exist in these budgets. This issue of constraints and flexibilities is important in several situations.

Under normal operations shifting the allocation of funds from one budget unit to another within an institution is often necessary. For example, enrollments may increase in engineering, requiring the addition of further funds for engineering faculty and laboratories in order to satisfy student demands. Or the establishment of a many-times-delayed computer laboratory finally becomes unavoidable. In such cases the institution must seek a source of funds to meet these new needs. If external funding sources, such as the state legislature, could be depended upon to fund each of these increased needs with additional revenue, the entire issue of budgetary flexibility would be of little importance. Since this is not likely to be the case, an analysis of sources of funds for new initiatives becomes imperative.

For institutions with unionized faculty, collective bargaining negotiations involve the search for funds that may be diverted to faculty salaries and benefits. Constraints that prevent the shifting of funds to these categories clearly have a negative impact on the outcome of negotiations from the point of view of the faculty.

Midyear budget corrections, as indicated in the preceding chapter, may be needed because of unforeseen decreases in revenue (caused, for example, by an unexpected drop in enrollment) or of needs to make unforeseen expenditures (caused, for example, by an unanticipated increase in utility rates or storm damage to buildings). Whatever the cause, budgeters are faced with the need to identify funds that can be moved into the needed category. Even more drastic needs for budgetary flexibility occur in fiscal crises.

PERSONNEL COSTS

Personnel costs for all employees at a college or university (including fringe benefits) typically constitute 60 to 80 percent of the institution's budget. When a fiscal crisis occurs, major personnel cuts may thus become unavoidable unless other funds can be shifted to meet crisis needs.

COLLECTIVE BARGAINING, PERSONNEL POLICIES, STATE REGULATIONS

Personnel costs are, however, constrained by many factors, including collective bargaining agreements, internal personnel policies, market factors, and state regulations. Salaries and benefits are specified for covered employees by most collective bargaining agreements for the duration of the contract. Salary increases are also usually specified by a percentage of the prior year's salary or by a dollar amount, although future salary increases are sometimes dependent on such factors as inflation, student enrollment, and/or state appropriations. Thus an institution that is unionized can precisely project salary costs into the future, provided that it can project the number of employees needed each year.

Furthermore, reasonable budgeters know that it is highly unlikely that faculty representatives will negotiate away substantial benefits that are currently enjoyed, except perhaps to avoid retrenchment. Thus the present level of benefits, and their future costs, provide a constraint in future budget projections.

Most collective bargaining agreements also specify faculty workload. These clauses prevent an administration from increasing the workload, and decreasing the number of faculty (and hence the overall cost of salaries and benefits), to meet a fiscal crisis. In fact, some agreements specify a maximum ratio of FTE students to full-time faculty. In those cases, the administration does not have the flexibility of not hiring additional faculty to meet increased enrollments.

Finally, most collective bargaining agreements contain termination clauses that specify the due-notice and/or severance

pay required to terminate employees. The last employees to be terminated, and those that receive the longest due-notice or the largest severance settlements, are usually tenured faculty. Unfortunately, many institutions have attempted to limit the number or percentage of tenured faculty on their staffs in order to maintain a degree of personnel flexibility. Some have established tenure quotas by department or by college, so that for a department at its tenure quota limit, no new faculty is granted tenure until a presently tenured faculty member leaves that department.

For tenured faculty, due-notice requirements for retrenchment are often specified in internal personnel policies as well as in collective bargaining agreements. Similarly for nontenured, full-time faculty, termination notice provisions are normally included either in a collective bargaining agreement or in the institution's own personnel regulations. Since most full-time nontenured faculty are appointed for one-to-three year periods, an alternative to terminating such faculty during the course of their contracts is not to reappoint them at the completion of their contracts.

State regulations constitute yet another level of constraints in personnel matters in those states that have adopted "position control" of faculty lines. This means that a vacant employee position results in the funding for the position reverting to the state rather than being available for use elsewhere in the institution. An administration may also be constrained from hiring additional regular full-time staff even when enrollments increase, and in such cases the institution may have no alternative but to hire part-time or temporary faculty or to increase class size to meet increased enrollments.

Some states have introduced a budgetary device called "salary savings," based on the fact that an institution never has all its budgeted positions filled all the time. When an employee leaves, some time may elapse before the position is filled. Historically, the savings have amounted to about 2 to 4 percent of the salary and benefits budget of an institution. In the past, most states have collected whatever salary monies were unspent at the end of each fiscal year. Under salary savings methodology, each institution is assigned a target for these sav-

ings at the beginning of the fiscal year. These targets are thus constraints on the expenditure of salary and benefit dollars.

But even though the salary savings budgetary device contains constraints, it also points to an area of flexibility and gives us a clear indication that the best way to achieve any necessary reductions in personnel costs is by not filling vacancies. The termination cost of eliminating a vacant position is zero. The cost of arbitration or litigation over the elimination of a vacant position is also zero. Thus, from both fiscal and humanitarian perspectives, the use of unfilled positions to meet budgetary problems is to be preferred. However, as described in the next chapter, not filling vacant positions may be sufficient to meet a fiscal crisis only when the institution has a relatively long time period in which to decrease its personnel budget by natural attrition.

Part-Time Faculty

Four arguments are often put forward to justify the use of part-time faculty in colleges and universities:

1. Part-time faculty provide flexibility for the institution. Since most part-time faculty are appointed to teach a given course for a given term they can simply not be reappointed if enrollments fall. Severance pay is usually nonexistent for them.

2. Part-time faculty represent a source of expertise that may not be present among the full-time faculty and may not be needed frequently enough to justify hiring a full-time faculty member with such expertise.

3. Part-time faculty may allow an institution to experiment with a new course or curriculum offering, at little financial risk to the institution.

4. Part-time faculty are less expensive than full-time faculty. In other words, if six courses per year constitute the load of a full-time faculty member at an institution, these six

courses could be taught less expensively by six part-time faculty members, each hired to teach one course, than by one full-time faculty member. Furthermore, the fringe benefits given to part-time faculty are usually substantially less than those of full-time instructors.

Nevertheless, there are a number of arguments against the excessive use of part-time faculty. They often teach at more than one institution and therefore may not have the kind of institutional commitment of a full-timer. They may be less available for advising students. They may not have the time for course and curriculum development. However, despite these and other arguments against using an excessive number of part-time faculty, nationally over 30 percent of the faculty at the rank of instructor and above are presently part-timers. In some two-year institutions 80 percent or more of the faculty are part-timers!

Because of the enormous importance of the part-time issue and the magnitude of the resources needed both to convert many part-time positions into full-time ones and to substantially increase salaries and benefits for the remaining part-timers, the NEA Policy Statement on Part-Time, Temporary, and Nontenure Track Faculty Appointments is included in this handbook (see Appendix B).

Rank Reduction

Another area of flexibility—and a variation on eliminating positions completely in order to meet budgetary goals—is replacing faculty who are leaving the institution with lower ranked faculty. For example, if a professor making $80,000 a year retires, the replacement could be an assistant professor making $35,000 a year. Similarly, an experienced secretary who leaves a department could be replaced with an inexperienced secretary at a lower rate of pay. Note, however, that although it may be perfectly reasonable to make both of these decisions in some cases, applying this policy systematically can lead to a serious distortion of departmental faculty and of academic support services.

NON-PERSONNEL COSTS

Many constraints are placed on the expenditure of non-personnel dollars. For example, institutions often enter into long-term agreements with outside vendors to provide housekeeping, security, building maintenance, and equipment maintenance. Thus if an institution has a three-year contract with a security firm to provide 50 guards per year, it has to take those 50 guards per year even if administrators want to cut the security force to 40 guards so that reductions will not have to be made elsewhere.

Long-term rental leases also have to be honored even if the institution no longer needs the space (although an institution should clearly include a clause in any such agreement permitting it to sublet the property).

In addition, payments must be made on outstanding institutional bonds or mortgages. Remember that issuing bonds in order to build facilities means that an institution must budget not only to maintain the facilities but also to repay the bonds.

Rate increases produce constraints—and spur searches for flexibilities. If the telephone company raises its local and long distance rates, for example, telephone charges could rise significantly. Institutions need to explore whether having their own internal telephone system rather using one provided by a telephone company would make cost savings available.

The cost of copiers could increase dramatically, due to increased usage or to increased rates paid for rental machines. The only way to contain these costs may be to restrict the use of the copiers.

An institution is also subject to the effect of increases in the rates charged it by public utilities. If the rate charged for electricity increases by 10 percent in a given year, the institution may have no choice except to pay the higher bill.

Chapter 4 mentioned the dramatic increases in prices for books and periodicals over the past few years. Further steep increases have to be anticipated. The only response possible for some institutions will be to further reduce purchases of these materials.

Inventories of academic and laboratory supplies may be increased or decreased, depending upon circumstances. An institution may wish to increase its supplies of stationery items if it knows that a large price increase for them is imminent. Conversely, it may wish to decrease certain categories of laboratory supplies in order to invest the funds tied up in inventory in revenue-producing securities.

Purchasing, however, is often constrained by state agencies for public institutions. State regulations may mandate advertising bids for any purchase or service contract over a specified amount. This may present no difficulty in some cases, but in others it may prevent cost savings that could be achieved by simultaneously negotiating a number of service contracts with a given vendor.

Travel represents one cost that is normally easy for an institution to control. As travel costs escalate, less travel is supported by an institution; and certainly in a fiscal crisis, travel expenditures will be drastically reduced.

GIFTS/ENDOWMENTS

Gifts may be restricted or unrestricted. Unrestricted gifts provide maximum fiscal flexibility and can be expended for any institutional purpose. Restricted gifts can be expended for special projects in a given fiscal year and can enhance the institution's endowment, the income of which can only be expended for the purposes of the endowment.

But even restricted funds or endowment income can substitute for unrestricted current funds. For example, if an endowment funds a faculty chair, the salary and benefits for that faculty member are paid out of earnings from the endowment, thereby relieving the current fund budget of that expense. Whether or not these funds can be used elsewhere in the public sector normally depends on the level of flexibility permitted the institution by the state.

GRANTS AND CONTRACTS

External grants and contracts have two revenue compo-

nents. One is the direct costs that pay for expenditures associated with the projects for which the grants or contracts were received. As in the case of gifts, grant funds can in some cases replace unrestricted current funds.

The other is the indirect costs that are paid by outside agencies on many grants and contracts and that may be used by an institution for any purpose. Once again, the only constraint on the use of these funds is state regulations, which might require that they be turned over to the state treasury.

RESEARCH INSTITUTES AND FOUNDATIONS

In order to avoid many of the constraints on the use of grants, contracts, and gifts, some institutions that receive substantial amounts of such types of external funding have established legally separate research institutes or foundations.

The research institute receives the grant or gift and performs the research. It can always retain the indirect cost part of the grant, and its finances are normally not under the supervision of the state. Purchases of research equipment may be made from the indirect costs received by the research institute rather than from university funds. Salaries and benefits for university personnel working on the research projects are partially or fully paid by the research institute.

ACCUMULATING RESERVES

If an institution has reserves that can be expended for any purpose budgeting becomes easier. Many institutions budget a contingency line and use it to meet unforeseen financial difficulties or to take advantage of unexpected opportunities. The amount budgeted for contingency is usually small, on the order of 1 percent or so of an institution's budget. By the end of the year these funds have either been transferred to operating budgets or into institutional reserves.

The term *quasi-endowment* is used to describe accumulated past surpluses of an institution, that is, unrestricted revenues that exceeded unrestricted expenditures. Unlike a true endowment, quasi-endowment may be expended for any pur-

pose by the governing board. An institution with a substantial quasi-endowment has little difficulty in meeting an unexpected fiscal problem since it can always transfer funds from its quasi-endowment into its current fund to meet the problem. However, in the public sector many states take back unexpended funds from an institution, making it impossible for the institution to establish a quasi-endowment. As can be expected, such institutions often spend budgeted funds heavily near the end of a fiscal year. There is little incentive for them to return funds to the state.

BLOCK APPROPRIATIONS

It is clearly in the interest of institutions to receive their entire state appropriations as a block award, which can be expended for any purpose. Just as clearly, this is not likely to happen for all institutions in the foreseeable future. However, continuing efforts should be made to obtain at least some portion of the state appropriation as a block grant. In addition, efforts should be made to allow institutions to retain some portion of unspent current fund revenues. For public institutions, these two budgetary changes might go a long way in reducing fiscal crises, the subject of the next chapter.

Chapter 6. Fiscal Crises

Probably nothing short of loss of accreditation is as traumatic for the educational community as a serious financial crisis. Such crises tend to result in adversarial stances between faculty and administrators (with students often caught between the two sides) and even among faculty themselves. Faculty may find themselves threatened in three ways. First, their salary increases may not keep pace with inflation. Second, their teaching loads may be increased. Finally, they may find themselves terminated or their colleagues replaced by part-time faculty. Consequently, recognizing the difference between a normal reallocation of resources and a true fiscal crisis is imperative. It is also helpful to be able to measure the severity of a fiscal crisis and to suggest alternative courses of action for dealing with it.

REALLOCATION OF RESOURCES

The first factor to consider if an institution declares a fiscal crisis is whether the situation is a real crisis or merely a normal reallocation of resources. Frequently budgetary crises are confused with ongoing needs to reallocate scant resources. For example, student enrollment patterns may change so that one department or college has too few students for the size of its faculty while another department or college has too many students for it faculty to service. The need to add new faculty to the over-enrolled department or college is obvious. But where will the funds come from to pay for these new faculty? One solution would be to fire the faculty in the under-enrolled department and hire new faculty in the over-enrolled department. But to do this to meet each new enrollment trend would result in constant warfare between the faculty and administration as well as the demoralization of the faculty. Fortunately, there are less destructive ways of reallocating resources.

Distinguishing a normal reallocation problem from a fiscal crisis is relatively easy. Note first, however, that normal reallocation problems that are ignored can eventually lead to a true

fiscal crisis. Thus recognizing and solving reallocation problems before they become severe is important. In a normal reallocation case, the overall institutional income will not be predicted to decrease in subsequent years. Instead, overall institutional resources will probably be projected to increase at a rate about equal to that of inflation. Similarly, overall enrollments will be level or perhaps even projected to increase slightly. The institution may assert that inflation (including salary and benefit increases) will use up all of its projected increase in income and thus it will not be in a position to support any overall increase in staff, and that for additional faculty to be hired in one area, the number of faculty need to be reduced in another area. Let us consider this assertion further.

Chapter 5 contained a discussion of the flexibility in college and university budgets. We saw that personnel do account for 60 to 80 percent of the expenditures of an institution, but that there is substantial flexibility in personnel costs if there is sufficient time in which to implement changes.

Remember that normal reallocations rarely require sudden massive shifts in resources. Since most such reallocations will be driven by changing enrollment patterns, and these patterns change gradually with time, institutions will have several years to cope with the problem, providing that action is initiated early enough. In order for this to occur, however, the institution needs to have in place a regular schedule of program review. But in order for a review to be effective, an institution must have adopted an orderly planning process involving several components: First the institution needs to have a detailed mission statement against which to judge its programs. Second, an institution must have detailed personnel procedures that cover such matters as termination of service, length of appointments, and early retirement plans. In institutions covered by collective bargaining, the contract probably includes these items. Third, the institution needs to have a set of planning principles, which should include the collection of appropriate data on which to make enrollment projections. Finally, the institution needs to have a list of principles and procedures for reviewing programs.

Since these program reviews could lead to a decision to reduce or even eliminate a program, consider some guidelines that might be incorporated in the review process. The American Association of University Professors has taken the position[3] that the termination of a tenured faculty member or of a nontenured faculty member before the completion of the faculty member's term of appointment may occur only because of a bonafide *financial exigency* (which will be discussed later in this chapter) or because of the *discontinuance* of a program or department for educational reasons. AAUP regulations do permit the dismissal of a faculty member "for cause," but that type of dismissal is unrelated to the fiscal issues in this chapter. The AAUP regulations state as follows:

- *The decision to discontinue ... will be based essentially upon educational considerations, as determined by the faculty as a whole or an appropriate committee thereof. (Note that "educational considerations" do not include cyclical or temporary variations in enrollment. They must reflect long-range judgements that the educational mission of the institution as a whole will be enhanced by the discontinuance.)*
- *Before the administration issues notice to a faculty member ... the institution will make every effort to place the faculty member concerned in another suitable position.*
- *A faculty member may appeal a proposed relocation or termination resulting from discontinuance and has a right to a full hearing before a faculty committee.*

Administrative organizations have taken exceptions to these guidelines. Among their objections are that the AAUP guidelines do not allow consideration of "cyclical or temporary variations in enrollment" in determining whether to reduce or eliminate a program. The phrase *cyclical or temporary* is undefined. Is a five-year decrease of 50 percent in the enrollment in a program "temporary"? Another objection is that the AAUP guidelines permit an administration only one of two options: closing a department or program completely, or not retrench-

ing any tenured faculty in it for "educational considerations."

Administrators go on to argue that, while purely enrollment driven formulas are not desirable, they are the mechanism that some states use in setting appropriations for higher education. How, then, can public institutions of higher education ignore enrollments in their fiscal planning?

Donald Cell, a former national officer of AAUP, argues in favor of accepting enrollments and the more traditional academic values as legitimate components of AAUP's "educational policy." He states that "enrollments more fundamentally reflect values held by students which, while we sometimes need to challenge them in the classroom, we should at the same time respect."[4]

Despite the AAUP policy statements to the contrary, administrations are likely to continue to use changes in enrollment patterns as reasons for reducing (or even eliminating) programs. However, there are many personnel actions that can greatly mitigate the adverse effect of these decisions on faculty. The magnitude of the impact of these actions depends upon the time period over which the staffing changes must be accomplished. These actions include the following:

1. **Not replacing any faculty who leave the departments that are experiencing serious declines in enrollment.** This seems obvious, but its application could present some problems for departments that an administration wishes to reduce in size but not eliminate completely. The best faculty in the department tend to be the most mobile and hence the most likely to obtain a position at another institution. If, for example, all of the senior faculty were to leave, continuing an effective program without hiring any replacements might be difficult. Also, a faculty member with a subspecialty that is crucial to the program may need to be replaced.

2. **Not renewing contracts of nontenured faculty.** Although this will create a hardship for these junior faculty, and may also effect the institution's affirmative action program, it seems less severe than the retrench-

ment of tenured faculty. Note that if the department has been employing part-timers, their nonrenewal will eliminate the least expensive faculty in the department. Put another way, the dollar reduction per faculty line reduction will be the smallest for part-timers.

3. **Transferring tenured faculty to suitable teaching positions in other programs.** Institutions should be willing to retrain faculty for duties in alternative programs, including subsidizing formal graduate study by them. Some institutions have interdisciplinary programs that are staffed by faculty from many departments. These programs may be able to utilize faculty from overstaffed departments with little retraining.

4. **Establishing early retirement plans.** Faculty (and perhaps staff) who satisfy specified age and service requirements are able to retire early. The forms of these plans vary considerably. Some institutions offer to contribute additional funds to private or state retirement plans so that the retiree will not lose out on the contributions that would have been made had the employee retired at the "normal" retirement age. One plan, at Temple University, involved paying one-third of a faculty member's academic year salary and most fringe benefits for up to seven years or until the retiree reaches age 67, whichever came first. Other plans pay a faculty member full salary for one or two years. The advantage of a plan such as Temple's, which paid one-third of a salary for a given period of time, is that the institution experiences an immediate reduction in its payroll on the day the faculty member retires—namely two-thirds of the member's salary that will not be spent. However, accrual accounting rules now require the institution to "book" the early retirement plan costs in the fiscal year in which the faculty member retires since it represents an obligation of the institution. Thus the accounts of the institution reflect the entire retirement cost in budget year one, even though the payments will not be com-

pleted for years. Later year budgets then reflect no cost (and perhaps even reflect credits) as the payments are made to the retirees.

These early retirement plans will help solve the reallocation problem only if the individuals using such plans are from departments whose enrollments are decreasing. Thus, many early retirement plans are restricted to faculty from departments with falling enrollments. Faculty taking early retirement are then not replaced, resulting in a net financial saving that can be used elsewhere in the institution.

The effectiveness of early retirement plans to reduce the faculty of given departments will depend on at least two factors: the terms of the retirement plan and the average age of the faculty.[5] Clearly, a more generous plan would interest more faculty than a less generous one. Also, early retirement plans will intrinsically be more appealing to faculty members in their late 50s or early 60s than to younger faculty members. Generally, when a new early retirement plan is introduced, the retirement rate increases substantially. It then decreases to a rate somewhat higher than that before the plan was introduced.

5. **"Buying out" a faculty member's contract or tenure.** Here, unlike the early retirement plans, there are no age requirements for eligibility. Buyouts are usually offered to all members of a given department or college. The amount of the buyout varies with one or two years of salary common for a buyout of a tenured faculty member. The faculty accepting these buyouts are often the most mobile faculty, who can quickly find a position elsewhere. Those who are less mobile and too young to retire are less likely to take a buyout. A modification of this is a partial buyout in which a faculty member is guaranteed a part-time appointment for any number of years up to a maximum. The benefits package might be

continued in part or in whole, and each year as a part-timer might count as a full-time year for purposes of retirement pay.

The longer the period of time an institution has to achieve a specified level of reduction in faculty in a department, the more likely that these five personnel policies will bring about the desired level of reduction without the involuntary termination of tenured faculty. But how long we can expect to have to achieve the staff reduction depends in part upon how early the enrollment problem was identified.

In a given department or program, we might expect to have at least three years to accomplish a significant reduction. Students already in the program will need two or three years to complete their courses. If the department is continuing, but at a reduced size, the course offerings will probably be reduced and the curriculum for a major modified. This time span is not unreasonable since enrollment patterns rarely change more than 10 percent per year. If the institution offers reasonable early retirement plans and buyouts, the staff could probably be reduced by 10 percent per year without any forced terminations.

However—and this is critically important to recognize—a department should not assume that a decrease in enrollment in the future is inevitable. In the example just given, a department's faculty may be able to stem the decrease by offering new services or elective courses, by offering minicourses on a weekend, by expanding evening offerings, or by asking that admissions policies be changed to increase admissions in areas in which enrollments have decreased. Many predictions of disastrous enrollment declines have turned out to be incorrect. Academia was warned by statisticians that major enrollment decreases were likely to take place in the early 1980s because of demographics. The demographics were, of course, correct, but the conclusions drawn from the statistics were wrong. The percentage of high school graduates who immediately went on to college increased as did the percentage of women over 25 who enrolled in colleges. These two factors more than offset the demographic downturn in 18- to 24-year olds, and overall

college enrollments in the nation increased. Similarly, aggressive marketing of a department, coupled perhaps with some changes in an institution's required courses, may eliminate or drastically reduce enrollment problems. Of course, some external factors that adversely effect enrollments are difficult to overcome. For example, if Washington slashes student aid and student loan appropriations, college enrollments by economically disadvantaged students are almost certain to decline.

REAL FINANCIAL CRISIS

In considering the types of fiscal problems that are closer to real crises than the "normal" reallocation problems discussed above, we must begin by considering some definitions. AAUP's 1982 "Recommended Institutional Regulations on Academic Freedom and Tenure" state in part as follows:

> *Termination of a faculty member's appointment with continuous tenure, or of a probationary or special appointment before the end of the specified term, may occur under extraordinary circumstances because of demonstrably bona fide financial exigency, i.e., an imminent financial crisis which threatens the survival of the institution as a whole and which cannot be alleviated by less drastic means. . .*
>
> *(Note: . . . there should be a faculty body which participates in the decision that a condition of financial exigency exists or is imminent, and that all feasible alternatives to termination of appointments have been pursued.)*
>
> *(The responsibility for identifying individuals whose appointments are to be terminated should be committed to a person or group designated or approved by the faculty. . .)*

The faculty member (given notice of a proposed termination) will have the right to a full hearing before a faculty committee. . .

The issues in this hearing may include:

- *The existence and extent of the condition of financial exigency. The burden will rest on the administration to prove the existence and extent of the condition.*

- *The validity of the educational judgements and the criteria for identification (for faculty members) for termination; but the recommendation of the faculty body on these matters will be considered presumptively valid. . .*

If the institution, because of financial exigency, terminates appointments, it will not at the same time make new appointments, except in extraordinary circumstances where a serious distortion in the academic program would otherwise result. . . .The appointment of a faculty member with tenure will not be terminated in favor of retaining a faculty member without tenure, except in extraordinary circumstances where serious distortion of the academic program would otherwise result.

Before terminating an appointment because of financial exigency, the institution, with faculty participation, will make every effort to place the faculty member concerned in another suitable position within the institution.

In all cases of termination of appointment because of financial exigency, the place of the faculty member will not be filled by a replacement within a period of three years, unless the released faculty member has been offered reinstatement and a reasonable time in which to accept or decline it.

Although these AAUP guidelines define financial exigency as "an imminent financial crisis which threatens the existence of the institution as a whole," in the public sector it is highly unlikely that any state legislature would ever allow a state college or university to close under such circumstances. For public institutions, the AAUP definition would be tantamount to an absolute no-layoff clause for tenured faculty.

Some court decisions have disagreed with the AAUP guidelines for retrenchment. In the 1977 *Scheuer v. Creighton University* decision the court stated as follows:

> *We do not accept the 1976 recommendations of AAUP defining "financial exigency" so as to limit that term to an imminent crisis which threatens the survival of the institution as a whole.*
>
> *To accept plaintiff's definition would require Creighton to continue programs running up large deficits so long as the institution as a whole has financial resources available to it. The inevitable result of this type [of] operation would be to spread the financial exigency of one school or department to the entire university. This could likely result in the closing of the entire institution.*
>
> *Common sense dictates that plaintiff's contention is untenable. To sustain it, we must hold no tenured employee in any college be released until the institution exhausts its total assets or at the very least reaches the point where its very survival as an institution is in jeopardy (199 NEB.618, 260 N.W. 2d, 595, 1977).*[6]

Other court decisions have used other definitions of financial exigency. In *Krotkoff v. Goucher College*, the Fourth Circuit Court defined it as "the adequacy of a college's operating funds rather than its capital assets."[7] Under the Fourth Circuit definition, a college could have large capital assets and still declare financial exigency. In AAUP v. Bloomfield College, capital assets were taken into account.[8]

At institutions with collective bargaining agreements, the

faculty or its representative may be reluctant to take "responsibility for identifying individuals whose appointments are to be terminated" because of the divisive affect on the bargaining unit if the faculty union plays a role in selecting those who will be terminated. Furthermore, the union might face a lawsuit for failure to represent those terminated. Most unions would prefer to let the administration select individuals for termination and then challenge the selections through grievance and arbitration proceedings.

Often, administrations have not used the term *financial exigency* to describe a fiscal crisis but used instead such terms as *state of urgency* or *financial stringency*. Whatever the term used, the accompanying comments by administrators should clearly indicate that they view the situation as either a potential or real fiscal crisis.

How can we estimate the severity of a fiscal crisis? Two pieces of information are crucial in making such an assessment. The first is knowledge of the precise cause of the crisis so that we can determine if it is a one-year or an ongoing recurring problem. For example, a continuing decline in enrollment for an institution as a whole, and the corresponding decrease in tuition revenue and/or state appropriation (which may be determined by an enrollment driven formula), might be ongoing or might improve dramatically in the near future, depending upon demographic projections for the geographic regions from which the institution draws most of its students.

Another possible cause for a fiscal crisis may be a decrease (or lack of an increase) in the state's appropriation for an institution. If the cause is a decrease in state revenues due to an economic recession, a relevant issue is the length of time that the recession is expected to last. In addition, is the legislature likely to raise the tax rate in a succeeding year to make up for the lower tax base (caused by the recession)? If the cause of the shortfall is a reduction in the tax rate enacted by the legislature, it may be that the entire state government will have to operate at reduced funding levels for a number of years. In that case, the institution's fiscal problems are going to continue for years to come unless other funding sources can make up for the loss of state funds. Another factor to consider in projecting state rev-

enues for the institution is whether or not the state's priorities for higher education funding are likely to be significantly effected by future legislative and/or gubernatorial elections.

The second crucial piece of information is an accurate estimate of the severity of the fiscal crisis. Here there are two parameters to consider:

- What is the dollar amount of the crisis? That is, how many dollars annually must be achieved through increased revenues and decreased costs? Note that a fiscal crisis can be resolved by finding new revenue sources or expanding existing ones. The problem does not have to be solved through budget cuts alone.

- What is the length of time available to resolve the difficulty? The time frame is generally shorter than in the typical resource reallocation described earlier in this chapter. The problem may have to be solved in a given budget year, which has already started. The shorter the period of time available to achieve a given level of budget cuts and/or increased revenues, the harder it will be to reach the level without drastic actions.

Faculty faced with a fiscal crisis should request access to the institution's financial records if they do not already have such access. In public institutions, state regulations may require that these records be made available to the public. An issue that a faculty committee must address in examining the financial records is whether or not its members have sufficient budgetary experience to analyze the situation properly. A fiscal crisis is often the worst situation in which to learn about budgets because of the speed with which decisions have to be made. Ideally, each institution should have in place a faculty budget committee whose members have gained some degree of budgetary expertise before the fiscal crisis occurs.

The financial records should indicate the total unrestricted fund balances in all of the institution's funds. Remember, as described in Chapter 2, the budget of an institution is reflected in more than simply its current fund (or general fund or simi-

larly named fund). Rather the budget is reflected in all of the institution's funds. If the total of all the unrestricted fund balances at the end of the year is $5,000,000, then the institution might be able to use this amount to meet the crisis if it wishes to do so. Be careful not to assume that all unrestricted fund balances are available to meet the crisis. A balance in the unrestricted retirement of indebtedness fund at the end of the previous year might be needed for debt retirement in the current crisis year. Recall, too, that investment in plant will be treated as unrestricted funds beginning in 1995-96, as described in Chapter 2.

Administrators sometimes state that they are "restricted" from using some unrestricted funds. However, these "restrictions" may only be resolutions of a governing board of the institution. Often governing boards designate some of these unrestricted funds for specified purposes. In that case it is true that the officers of the institution cannot spend the funds for other purposes, but the governing board can redesignate these funds at its next meeting if it chooses to do so. By contrast, funds that are restricted (according to accounting standards) cannot be used for purposes other that those stated for them by external agencies or individuals. Truly restricted funds cannot be used for other purposes by either the institution's administrators or its governing board.

The total of these unrestricted fund balances (less the net investment in plant) can provide a measure of the severity of the crisis. If the unrestricted funds exceed the size of the fiscal crisis, part of the problem can be met by using these funds. However, governing boards will generally be reluctant to use up these unrestricted funds because they represent a major component of the flexible resources available to an institution. These funds may have been accumulated over many years.

In considering the use of an institution's reserves to cover a fiscal crisis, a three-to-five year projection of revenues and expenses should be prepared. If fiscal stability cannot be achieved in the time frame without taking actions in addition to the use of reserves, then additional actions will probably have to be taken. If the crisis involves a decrease in income

that is likely to continue for a number of years, it may indeed be imprudent to use up an institution's reserves in meeting the crisis for only the first year. As already noted, knowing the detailed cause of the fiscal crisis and whether or not it will continue for a number of years is important. If it is only a one-year crisis, a governing board may be more likely to approve the use of institutional reserves to meet it.

Needless to say, if there is a contingency line in the institution's budget, it should be used to meet the crisis. However, if the budgeted contingency funds were sufficient to solve the problem, it is unlikely that a fiscal crisis would have been announced.

If the degree of the crisis exceeds the unrestricted fund balances of the institution, the crisis is probably going to be severe, unless it is a one-year-only nonrecurring crisis, such as a large liability judgement against the institution not covered by insurance. A solution to this kind of crisis might be to borrow some of the needed money, which would then be repaid over a number of years. In that case, the institution must find the funds to make the annual payment to the banks, but that may reduce the amount of other expenditures that would have to be cut by a factor of four or five if the payments (including interest charges) are spread over four or five years.

Suggestions for Increasing Revenues

Naturally, solving a fiscal crisis by increasing revenues is less painful than by reducing expenses. What follows are some useful revenue enhancement suggestions to consider, although not all are appropriate for all institutions or fiscal crises.

1. *Raise tuition, fees and room and board charges.* Consider adopting different tuition rates where high cost or high demand programs charge higher tuition. Also consider imposing higher tuition for juniors and seniors, who are very unlikely to leave the institution because of a somewhat higher tuition rate (justified by higher instructional costs). Public institutions could consider increasing the number of nonresident students (who are charged higher tuition rates).

2. *Increase enrollments.* Offer additional courses and workshops to attract students, conduct minicourses over weekends, or offer courses on the premises of area businesses. Compare the enrollment trends at nearby institutions. If enrollment decreases have occurred at your institution, were comparable decreases experienced at other area institutions? If the answer is "no," examine the recruitment program of your institution. Unless someone has a convincing explanation as to why only your institution is suffering an enrollment decline, this examination may reveal ways of substantially improving recruitment.

3. *Improve student retention.* One way to offset fewer students arriving on your campus is to reduce the number of students who leave without completing their program. For example, it is not unusual for public urban universities to have a forty to fifty percent attrition rate at the baccalaureate degree level. In these institutions, forty to fifty percent of the entering freshmen do not receive a bachelor's degree from the institution. Obviously faculty could play a decisive role in improving retention rates by involving themselves in student advising, offering tutorial sessions to students, and decreasing the depersonalization of higher education.

4. *Increase research geared to the needs of business, industry, and government*—thereby increasing both direct grant income and indirect cost income. Increase the charging of academic year salaries to grants and contracts, thereby reducing salary and benefit charges to the unrestricted current fund.

5. *Change the investment portfolio.* Sacrifice growth to some extent to maximize current income.

6. *Use a "total funds approach" to budgeting,* thereby reducing current fund expenditures by replacing them with other funds available to budget units.

7. *Increase unrestricted gifts* by emphasizing them in fundraising. Pursue fundraising strategies more aggressively.

8. *Form private practice plans* similar to a physicians' practice plan in which medical fees are paid directly to the institution. The physicians share the revenues generated with the institution. The plans could generate more income for both faculty and the administration. Possible areas in which to consider such plans are business, architecture, engineering, and some of the basic sciences.

9. *Try to increase the state appropriation.* This is an obvious action for any public institution, but it may also yield positive results for a private institution in financial distress.

Suggestions for Decreasing Expenses

None of the possible cost cutting measures on the following list will be well received by all institutional constituencies, and only some may be appropriate for a given crisis. They are listed in no particular order.

1. *Postpone major building projects.*

2. *Defer building maintenance* as much as possible.

3. *Reduce the costs in auxiliary enterprises.* Reduce the net subsidy of auxiliaries. If the crisis is serious enough, close some or all of the auxiliaries that lose money. Consider "privatizing" some auxiliaries such as the university bookstore or student food services so that the institution is guaranteed to break even or perhaps make a profit on an auxiliary that was losing money.

4. *Encourage greater use of word processing technology* in order to reduce clerical staffs.

5. *Reduce expenditures for equipment,* furnishings, typewriters, and computers, except when enhanced use of computers may allow other economies, or the use of modern technology may allow the reduction in, for example, the number of security personnel that are needed for a given campus. In order to achieve this reduction, the institution may need to place extraordinary administrative controls (for the duration of the crisis) over the spending authority of deans and budget unit heads to delay for a year all nonessential purchases and reduce inventory.

6. *Reduce the size of administrative overhead* by eliminating duplication. This might include combining two or more small colleges into a larger one, saving the salary of the deans, assistant deans, and other staff.

7. *Seek advertisers for certain university publications,* such as alumni publications, in order to reduce the cost to the unrestricted current fund of publications.

8. *Investigate the purchase of a new telephone system* to reduce telephone charges. Review all existing phones and remove nonessential ones.

9. *Monitor duplication charges* to see if they can be reduced without impairing operations.

10. *Reduce travel and entertainment charges.*

11. *Reduce external consultants,* and replace them with faculty.

12. *Reduce or eliminate non-need-based scholarships.*

13. *Reduce library expenditures.* Make better use of interlibrary loans and new technologies to offset fewer new acquisitions.

14. *Consider making summer school or evening courses part of the general workload.* This may provide work for underutilized faculty and minimize layoffs. For example, a faculty member might teach in the fall semester and during summer school and have the spring semester off instead of the summer off. The institutional savings result from not having to pay extra money for summer school or evening course instruction.

15. *Consider increasing class size,* thereby reducing the need for part-time and temporary faculty.

16. *Do not fill faculty vacancies.* Cross-train faculty so that over-staffed departments can provide needed faculty elsewhere rather than hiring from the outside. Avoid course duplication and reduce the number of course selections to reduce total needed faculty.

17. *Offer early retirement plans,* as described in the first section of this chapter.

18. *Offer buyouts to faculty* in under-enrolled departments.

19. *Eliminate or reduce intercollegiate athletics,* unless a sport makes money for the institution.

20. *Reduce or eliminate expenditures for public service functions* of the institution. This action might bring some public pressure to bear on legislators to assist the institution in meeting its fiscal crisis.

21. *Reduce overtime.* However, in some circumstances, overtime is more cost effective in providing needed services than hiring additional employees.

22. *Conduct an energy conservation program* for employees. Light, heat, and air conditioning do cost money.

23. *Increase student employment* as a substitute for other employees where practical.

24. *Change the calendar* if this might increase enrollments or decrease energy costs or do both.

25. *Change the workday* to better utilize space. If a longer workday (staggered for employees) permits more work and more classes to be taught in a given building, then some facilities may not need to be kept open at night, for example. In some cases the institution may not need some of its current buildings, thereby saving energy, cleaning, maintenance and security costs.

26. *Sell unneeded land and buildings*, such as a sports field that is no longer used.

27. *Where possible employ 9- or 10-month employees rather than 12-month employees* since the summer months may not require as large a staffing level as during the academic year.

28. *Reduce or eliminate visiting scholars and lecturers.*

29. *Charge budget unit heads for some central services* they now receive free, such as research computing. This may reduce usage and costs.

As already indicated, many of these suggestions will not be well received by faculty, staff, and students. They may be less damaging, however, to the institution than such possible alternatives as salary freezes, layoffs of regular part-time and full-time untenured faculty, and termination of tenured faculty.

Some of these suggestions for decreasing expenditures and all nine suggestions for increasing revenues should be examined by appropriate faculty and administrative groups even in the absence of a financial crisis. For example, if a changed calendar can increase enrollments and decrease costs, then adopting it could provide funds for additional salary

increases or the purchase of new instructional equipment.

Reported Responses to Fiscal Problems

What actions have actually been taken to meet real or perceived fiscal crises? When James Mingle surveyed a number of institutions that had experienced such problems, he catalogued the responses chosen by the institutions in ascending order of the perceived seriousness of the financial crisis.[9] Thus, the first cutback (restricted travel, telephone, supply purchases) was perceived to be in response to the least serious fiscal problem.

In order of increasing severity, the reported responses were as follows:

- Restrict travel, telephone, supply purchases
- Postpone equipment purchases
- Cut library budget
- Tighten tenure requirements
- Reduce energy costs
- Employ part-time faculty in place of full-time faculty
- Reduce secretarial staff
- Defer maintenance and renovation projects
- Adjust investment policy to maximize short-term gains
- Reduce class offerings; increase class size
- Increase tuition, room and board fees
- Initiate a student health fee or increase other special fees
- Require larger/earlier deposits
- Reduce number of resident advisors, counselors, other student service personnel
- Eliminate general fund support for intercollegiate athletics
- Initiate special one-time surcharges to students
- Lease, convert, or close excess dormitory space
- Impose a hiring freeze—reduce costs through attrition
- Cut staffs of public information, alumni offices
- Reduce or eliminate summer school offerings
- Terminate professional administrative staff (such as associate deans, assistant vice presidents)

- Close the university press
- Close the natural history/art museum
- Eliminate the intramural sports program
- Reorganize the governance structure—eliminate "colleges," "departments"; replace with "divisions"
- Eliminate low producing/low priority elective courses; terminate nontenured faculty who teach them
- Discontinue low priority academic programs; transfer tenured faculty to related departments
- Declare a state of financial exigency; close major academic units, departments, colleges, schools
- Terminate tenured faculty
- Merge institution with stronger institution
- Close the institution.

This list represents, according to Mingle, how administrations have generally dealt with fiscal problems. There is nothing mandatory about the order of the actions taken. Financial crises have sometimes resulted in quite different responses being followed.

Chapter 7. Budgetary Information

Budgetary analysis is dependent upon available budgetary data. This chapter reviews the data that may be obtained about a given institution and, in some cases, about comparable institutions.

Ideally, administrators of all institutions should share budgetary data with an appropriate faculty group, such as a faculty senate budget committee . When this is the case, the sources of budgetary data described in this chapter will probably be utilized only to the extent that comparison with other institutions may be helpful in assessing performance.

Public institutions are mandated by state law to provide a variety of financial information that is open to the public. Appropriation bills for each institution are a matter of public record. In some states the appropriation is determined by a formula (as described in Chapter 3) . If the formula includes a group of comparable institutions where faculty averages are used to calculate one of the terms in the formula, it is useful to compare the average salaries of faculty at your institution to those of its comparables. Copies of the funding formula, and such details as which institutions are the comparables, should be available from the state bureaucracy that supervises the formula.

States usually publish reports that evaluate the effectiveness of state-supported institutions. These reports are issued by a department of education, another executive branch operation, or perhaps by an agency reporting to the legislature. They may contain enrollment statistics, faculty salary data, workload averages, and the calculations of the cost of instructional output, such as the cost per student credit hour produced, which may be differentiated by level as well as by discipline. In some states faculty salaries are a matters of public record. In institutions in which the faculty are unionized, the faculty representative usually has a legal right to the listing of salaries and benefits of the members of the bargaining unit, plus other necessary data.

Faculty may also wish to examine the budget submission of the institution to the state government. Some states mandate separate budget requests for capital appropriations, and the capital requests may state the needs of the institution, in priority order, for several years into the future. When this is the case, faculty may be able to identify administration priorities from the capital budget request.

Some of this data may also be available from the appropriate state agencies for private institutions. In addition, financial information is submitted annually to the federal government by institutions of higher education. The data are compiled by the U.S. Department of Education, National Center for Education Statistics in Washington, D.C. The data from this center are then used by a number of organizations to analyze the state of higher education.

Each institution has to file an annual report with the Internal Revenue Service (IRS) as an organization exempt from income tax. The report, filed on Form 990, contains a statement of revenue, expenses, and changes in fund balances. It also contains a beginning and end of fiscal year balance sheet, including a listing of the value of land, buildings and equipment owned by the institution as well as a listing of mortgages, bonds, and other notes payable. Finally, it lists the salaries and fringe benefits of the chief administrators of the institution. Many faculty unions obtain a copy of their institutions' IRS report each year. Note, however, that the report received will probably be at least a year old. For example, in response to a request in the Fall of 1996, you may receive your institution's IRS report for the fiscal year July 1, 1994-June 30, 1995.

The American Association of University Professors annually obtains and analyzes faculty compensation data from about 1,900 institutions covering about 350,000 full-time faculty. For each of these institutions, the AAUP report presents the average salary by rank and sex, and the number of full-time men and women in each rank in the institution. It also presents fringe benefits as a percentage of salary and the percentage of salary increase that each rank at the institution received that year for continuing faculty. The AAUP survey assigns a

rating to the average compensation in a given rank. The data also include the percentage of tenured faculty. Thus you may ascertain from the data how salaries, benefits, and salary increases at a given institution compare to those at similar institutions. This report is published annually in *Academe*.

The National Education Association makes a variety of data available through its Higher Education Research Center. The resources available to NEA higher education affiliates include:

• ***NEA Higher Education Almanac***—published annually the Almanac provides national salary data based on salary reports filed by colleges and universities with the National Center for Education Statistics. In addition the *Almanac* has chapters on faculty workload, the economic conditions in the states, the numbers and compensation of support personnel on the campuses, and trends in bargaining.

• **Salary Reports**—data on salaries for institutions in each state are provided to the states. In addition, the Research Center provides salary comparisons for peer institutions. The computer can select peer institutions based on enrollment and E & G expenditures (money spent on education and general purposes) or the affiliate can select its own peer institutions. Budget information on peer institutions is available.

• **Budget Analysis**—in 1993 NEA trained state staff in higher education budget analysis. In addition NEA can provide general information on budgets based on information filed by the campuses with the federal government. The Research Center is developing a software package that states can use to analyze campus budgets.

• **Higher Education Contract Analysis System**—the Research Center has provided the higher education staff with a software package that includes over 400 higher education contracts for faculty (full and part-time), support staff, and education professionals and a program that searches the contracts for specific language. The system is updated annually and is available on CD-Rom.

• **Resource Center**—Working with the University of Rochester, the NEA has established a Higher Education Resource Center to facilitate communications with its higher education members utilizing NEA On-Line and Internet. The center will collect key data on the status of higher education, analyze the data, and produce reports on topics of interest to NEA members.

Grapevine is a source of information for state higher education appropriations. It was distributed as a newsletter from 1958 to 1995. Beginning in the fall of 1995, it will be available over the *Chronicle of Higher Education's* Computer Network. The complete tabulation may also be made available on an Illinois State University Service. The data is compiled by the Center for Higher Education, Illinois State University, Campus Box 59800, Normal , Illinois, 61790-5900.

Appendix A: Annotated Bibliography

The following books and articles about college and university budgeting may be helpful in analyzing an institution's budget.

BOOKS

1. *College and University Budgeting: an Introduction for Faculty and Academic Administrators*, by Richard J. Meisinger and Leroy W. Dubeck. Published by the National Association of College and University Business Officers (NACUBO) ,Washington, D.C. in 1984. The second edition, by Richard J. Meisinger, was published by NACUBO in 1994. The book describes the budget process in great detail and contains an extensive section on the technical tools used in college budgeting.

2. *NEA Almanac of Higher Education*, published annually by the National Education Association. The Almanac contains a wealth of statistical information and analysis about the status of higher education during the prior year, faculty salaries, benefits and retirement trends in collective bargaining, faculty workload, state policy and budget developments, and support staff and administration trends.

3. *Financial Self-Assessment: A Workbook for Colleges and Universities*, published by NACUBO, 1987. This book provides a step-by-step method for assessing the strengths and weaknesses of an institution. It was written for college and university administrators, and the statistics needed to complete all of the evaluation calculations may not be readily obtainable by faculty. Thus an institution's administration needs to make available the needed data if faculty are to utilize the workbook fully.

4. *College and University Business Administration*, fifth edition, published by NACUBO in 1992. This three volume set is the basic reference manual for all phases of business and fiscal management of colleges and universities. It provides a good overview of all technical aspects of institutional accounting and contains discussions of financial indicators, financial planning and financial reporting.

5. *Recognition of Depreciation by Not -For-Profit Institutions*, published by NACUBO in 1988. The monograph explains the requirements of FASB Statement 93.

6. *Impact Assessment Guide for SFAS No. 116 and SFAS No. 117*, published by NACUBO in 1994. The book describes the required accounting changes and the preparation of the new financial statements.

7. *Responsibility Center Budgeting* by Edward L. Whalen, published by Indiana University Press in 1991. The book describes an approach to decentralized management for institutions of higher education.

ARTICLES

1. "Methods for Selecting Comparison Groups," by Paul T. Brinkman and Deborah J. Teeter, published in *Conducting Interinstitutional Comparisons, New Directions for Institutional Research* , No. 53 (San Francisco, Jossey Bass), spring 1987. This article describes the types of comparison groups that are used in higher education for such issues as formula funding of institutions, faculty salary comparisons, and relative efficiencies of institutions.

2. "Establishing Peer Groups: a Comparison of Methodologies," by Deborah Teeter and Melodie E. Christal, published by *Planning for Higher Education*, Vol. 15, No. 2, 1987. This article compares the method-

ologies used by the National Center for Higher Education Management Systems to those used by the State of Kansas to select peer institutions.

3. "Formula Funding in Higher Education: a Review," by Roger C. Noe, published in the *Journal of Education-Finance*, Vol.11, No.3, 1986. This article reviews formula funding in the literature and includes characterisitcs of formulas, advantages and disadvantages, and future trends. It contains 60 references.

Appendix B

National Education Association Report and Recommendations on Part-Time, Temporary and Nontenure Track Faculty Appointments

Introduction

The misuse and abuse of part-time, temporary, and nontenure track faculty appointments constitutes one of the most serious problems confronting American higher education.[10] This situation was recognized in 1976 by the National Education Association when it adopted the following policy resolution, which was amended in 1986:

> *The National Education Association believes that part-time faculty should be employed only when an educational program requires specialized training or expertise not available in the full-time faculty and when the need for such training and expertise does not justify more than half-time employment. Part-time faculty should receive the same salary and fringe benefits as full-time faculty prorated according to the workload. The Association also believes that part-time faculty should not be employed for the primary purpose of reducing instructional budgets or for the purpose of reducing the number of full-time faculty positions.*[11]

This resolution serves today as the foundation for a more comprehensive statement on part-time faculty and is clearly applicable to contending with the misuse of temporary and nontenure track appointments.

According to the NEA's 1986 *Statement on Academic and Intellectual Freedom and Tenure in Higher Education*, academic freedom, tenure, and educational quality are being "undermined by the excessive use of part-time faculty members." These faculty members are usually expected to work for substandard compensation, without security of employment or due process, and under conditions which "place at risk the

value of the education being provided to their students." NEA is concerned about the welfare of the individuals being exploited by this system and the ramifications of these practices in higher education.

The 1986 Statement also notes that similar conditions apply to full-time faculty in non-tenureable positions and concludes that, "Teachers and scholars who are subjected to lengthy or continuous probationary status are less likely ever to exercise freely their rights as citizens and as teachers." Tenure quotas and artificially high standards for earning tenure are also seen as having a debilitating effect on institutions. The 1986 Statement observes:

> *While NEA supports all proper efforts for an institution to seek and maintain academic excellence, it decries negative decisions on tenure motivated primarily by a desire to retain budgetary "flexibility." Such policies damage the morale of the continuing faculty as surely as they destroy the ideals and aspirations of their victims.*[12]

The NEA 1986 *Statement on Professional Compensation and the Finances of Higher Education* terms the hiring of part-timers "a false economy" and calls on institutions to hire qualified full-time faculty whenever possible. This statement recognizes only one legitimate use of part-time appointments (last-minute enrollment increases) and reconfirms NEA's 1976 resolution by calling on institutions not to appoint part-timers primarily to reduce instructional costs or the size of the regular, full-time faculty or academic staff.[13]

Categories

Categories of Part-Time, Temporary, and Nontenure Track Faculty

NEA recognizes that, just as American higher education is diverse, the misuse and abuse of part-time, temporary, and nontenure track faculty take different forms at the various types of institutions. This diversity makes it difficult to develop principles and policies to cover all variations. To attempt this process, however, the following categories of employment, defined by current use and policy, will be utilized or implied herein:

1. *Part-time faculty members*— instructors who have less than a full-time teaching load and are usually compensated at a rate below that of regular full-time faculty. Part-time faculty are divided herein into two sub-categories for the purpose of policy-making:

   a. *Regular part-timers*—those holding one (or more) part-time appointments and tending to establish long-term employment relationships with an institution through regular and repeated appointments. This group includes "full-time part-timers" (those who teach a full-time load for part-time compensation);

   b. *Irregular part-timers*—those who usually hold a full-time position elsewhere within or outside of academia and/or teach part-time only on an irregular or "casual" basis;[14]

2. *Temporary faculty members*—full-time appointees, retained on a short-term basis, usually a year or two, and for special purposes without reasonable expectation of continuing, long-term employment at the institution;

3. *Nontenure track faculty members*—full-time appointees retained to teach or conduct research who may have expectations of continuing, long-term employment without benefit of regular faculty status or the reasonable expectation of being tenured. In some institutions these individuals are appointed annually on term contracts, while in other institutions they enjoy forms of employment security similar to academic tenure.

4. *Regular, full-time faculty*—those faculty, nontenured or tenured, who are on the tenure track and enjoy full faculty status.

Excluded from this report are certain other categories of academic employment where abuses are known to exist, e.g., researchers supported by grant funds or soft money, and graduate and postdoctoral students who teach.

The Appropriate Use of Part-Time and Temporary Appointments

NEA recognizes that appropriate and legitimate uses of part-time and temporary faculty exist. First, when confronted by unexpected enrollment increases, especially in basic courses, institutions may appoint part-time and temporary faculty to teach classes when regular, full-time faculty are unavailable.

Second, when an institution decides to offer only one or two courses in a specialized area outside of the full-time faculty's areas of competency, it may legitimately make part-time and temporary, short-term appointments. Third, when an institution wants to initiate, or experiment with, a new course or program of study, it may appoint part-time or temporary faculty members for a brief period of time. Fourth, temporary faculty are frequently retained to fill in for regular full-time faculty on leave or sabbatical. Fifth, artists- or writers-in-residence are frequently and appropriately appointed on temporary contracts.

After reviewing all available data and reports on current practice in the academic community, such as the Carnegie Foundation's *College: The Undergraduate Experience*,[15] NEA concludes that part-time and temporary appointments are being used improperly at many institutions. Therefore, NEA offers this initial recommendation:

> *Colleges and universities should convert all improper part-time, temporary, and nontenure track appointments to regular, full-time faculty positions whenever feasible and as soon as practical, and adopt policies through faculty governance and/or collective bargaining that will prevent the improper and excessive use of these types of appointments in the future.*

Improper use is defined as all uses that do not meet the legitimate uses enumerated above.

Academic Due Process for Part-Time and Temporary Faculty Members

Part-time and temporary faculty members must be afford-

ed academic due process rights conforming to those of regular, full-time faculty.[16] These rights are best protected by procedures that include, but are not limited to:

1. timely appointment letters that clearly specify the nature of their relationship with the institution in the short and long term;

2. timely written notice of reappointment and non reappointment, the standards and criteria on which they will be evaluated for reappointment, and any change in the terms of their status or relationship to the department or institution;

3. academic due process, i.e., the right to confer over the terms and conditions of their appointment, the right to file grievances or appeal negative decisions, to have a fair hearing, and to receive timely settlement of their grievances. In particular, faculty must be guaranteed the right to complete the term of their contracts, except for just cause, and to appeal through appropriate procedures the premature termination of their contract;

4. fair and equitable evaluation by peers or other appropriate persons, with the results of such evaluation being given to them in writing and with an opportunity to respond and seek remedy.

Security of Employment for Part-Time Faculty

Institutions should provide qualified regular part-time faculty with suitable forms of employment security after an appropriate probationary period. The expectation of continuing employment, except for just cause, is the proven and accepted way to assure academic and intellectual freedom, and employment security.[17]

The appointment of large numbers of part-time, temporary, and other categories of instructional and research staff who are denied tenure or employment security, academic due process, and participation in faculty governance has a negative

effect on the morale of the entire institution.[18] Limitations placed on these individuals by such practices reduce the status of all instructional staff at the institution— tenured or non-tenured, full-time or part-time, regular or temporary.

Part-time faculty who are appointed repeatedly over an extended period of time should be evaluated through the procedures, and according to the standards, generally applied to full-time faculty appointments. Notice of nonreappointment should be given to these individuals according to the same standards of notice accorded to regular, full-time faculty.

Participation of Part-Time and Temporary Faculty in Governance

Part-time faculty, especially regular part-timers, and temporary faculty should be included in faculty governance and decision-making processes at the institution. Regular part-timers and temporary faculty should be involved along with full-time faculty in the determination of course content, goals, schedules, and instructional materials. They should also be involved in the overall evaluation of their courses. Regular part-time faculty should participate in the work of committees responsible for oversight and coordination of the courses or programs that they teach. Ways should be found to elicit formal suggestions and comments from all part-time and temporary faculty about their courses and other professional duties.

Regular part-time faculty should be appointed to committees responsible for making recommendations on policies governing the employment of part-time faculty and on hearing their appeals and settling their grievances. Representation is especially critical when their department or institution develops a comprehensive policy handbook or manual for part-time and temporary employment.[19]

Part-time and temporary faculty should seek to participate in faculty committees and decision-making processes as part of their professional responsibilities. The type and extent of participation will vary from institution to institution, as deter-

mined through faculty governance processes. These additional responsibilities would justify additional compensation, as set forth below.

Conditions of Part-Time and Temporary Faculty Employment

Institutions should recognize that part-time and temporary faculty need and deserve suitable working conditions in order to fulfill their professional responsibilities. Classroom and laboratory facilities should be conducive to teaching, learning, and other forms of educational and artistic endeavor. Part-timers and temporary faculty should have access to adequate office space in order to meet with and advise their students. They should be given adequate administrative services to facilitate their work. When research and publication are required for advancement or earning tenure, it is especially important that suitable facilities and support be available.

All new faculty members, including part-time and temporary faculty, should be given a comprehensive orientation about the institution, its mission and goals, the role of the faculty and other components, and the rights of faculty and students. Those beginning their career or new to the institution should be guided by regular, full-time faculty members whose workloads should be adjusted to accommodate significant responsibilities in this area.

Compensation of Part-Time Faculty Members

According to NEA's 1976 resolution, part-time faculty members should be paid at the same rate as their full-time colleagues. For part-timers this means pro rata salaries and fringe benefits. Salary levels should be based on credentials, experience, and, where the faculty and institution agree, the quality of their professional activities. Normally, regular part-timers, especially those with continuing appointments, should enjoy most of the fringe benefits, such as a retirement plan, accorded to regular, full-time faculty. Faculty development programs should also be opened to qualified part-timers.

Pro-rata compensation should reduce the use of part-time

appointments while increasing the number of regular, full-time faculty appointments. In all likelihood, the financial incentive for institutions to hire part-time and temporary faculty would be largely eliminated.[20] This was NEA's position in 1976, and it remains the best way to solve the current problem more than a decade later.

The implementation of such compensation policies may carry with it reasonable expectations that part-time faculty increase the amount of non-class time that they devote to their overall professional responsibilities.

The Abuse of Nontenure Track Appointments

Many colleges and universities have placed and continue to place large numbers of instructional and research faculty in a variety of nontenure track appointments, frequently at a sub-standard rate of compensation, usually without academic due process or expectation of earning tenure.[21] As with the use of part-time faculty, these widespread practices have contributed to concerns about the quality of our colleges and universities and the status of academic and intellectual freedom.

Normally, a temporary appointment should not exceed two years. Non-tenure track or temporary appointments should never be used as a substitute for the probationary period for faculty members who should be on the tenure track, although the institution may convert these positions into a tenure-track position for bona fide reasons with the consent of the faculty. In such cases, the individual should be given credit for full-time (and part-time) service toward the probationary period normally required for earning tenure.

Larger public university systems are perhaps the most guilty of hiring instructional staff on the nontenure track. Such appointments are frequently made in remedial programs, "writing centers," and service courses, such as teaching English as a second language.[22] NEA believes, as stated above, that these positions should be converted to tenure track positions since there is no compelling reason to deny these individuals the right to earn tenure.

When positions are converted to the tenure track, institu-

tions should take care to evaluate nontenure track faculty affected by the policy according to the standards and criteria appropriate to their duties and responsibilities at the institution. For example, if publication has not been a criterion for reappointment to the previous nontenure track position, it normally should not be introduced during the conversion process. Faculty members who have been fulfilling satisfactorily their professional duties in a nontenurable position should be accorded prior consideration during the conversion process. The standards and criteria for being appointed to the tenure track should not be raised to levels inconsistent with the responsibilities of the position in an attempt to preclude the retention of those currently employed.

Part-Time and Temporary Faculty in Collective Bargaining

Collective bargaining represents the best way to develop comprehensive policies for part-time and temporary faculty employment. Practice regarding part-timers in bargaining varies across the nation, and this diversity again makes it difficult to establish principles applicable to all institutions. Overall, there seems to be a recent trend toward organizing more part-timers and including them in full-time faculty units. (In most instances, full-time temporary and nontenure track faculty members have already been included in full-time faculty units.)

Considering the issues and the experience gained by NEA and its affiliates over the past two decades, it is growing more evident that full-time faculty generally are more aware of a community of interest with part-time and temporary faculty. If the policies proposed above are implemented—pro-rata pay and fringe benefits, due process, tenure, and governance rights— there would be little doubt about these categories of academics sharing a greater community of interest.

Where part-timers have been included in full-time units, policies have been developed that tend to eliminate both the abuse and misuse of part-timers.[23] If regular part-timers and temporary faculty are to be included in the faculty governance processes, it seems inconsistent to exclude them from full-time faculty bargaining units.

Although the NEA recognizes that each of its affiliates has the right to determine its own policy in this area, it calls on full-time faculty to consider seriously the representation of their part-time colleagues through their full-time units as an important step towards ending the misuse and abuse of these types of appointments.

Conclusion and Final Recommendations

Because of perceived financial necessity, the desire to maintain administrative "flexibility," and the availability of un- and underemployed academics, institutions have hired upwards of 300,000 part-time, temporary, and nontenure track faculty members instead of full-time, regular faculty. Although this practice may have helped institutions live within their budgets and meet enrollment increases, it has denied many qualified individuals full-time, regular academic employment. It has also created several under classes on campus which are separated from the "privileged" class of regular, tenure-track faculty. For many institutions, this practice has become an easy way to circumvent the tenure system and avoid a tenured-in faculty.[24]

Instead of grappling with the budgetary and personnel problems associated with tenure track faculty, institutions have created a revolving door situation featuring disenfranchised part-timers, "folding-chair" appointments, tenure quotas, unreasonable criteria for earning tenure, nontenure track appointments, "rolling" contracts, and other improper practices.

Recent studies of the American professoriate and undergraduate education clearly illustrate the negative impact of these practices on higher education. Unfortunately, few of these studies offer viable, concrete proposals for reversing these conditions and reclaiming academic integrity and excellence.[25] To reduce significantly the number of part-time and temporary faculty positions by converting them into regular, full-time positions will require major increases in financial support. To provide adequate support facilities for part-time and temporary faculty will also require additional financing.

Eliminating the misuse and abuse of part-time and tempo-

rary faculty will require major shifts in opinion among regular faculty members, administrators, and trustees. All must recognize the nature and extent of the problem and work together to resolve it. Extensive short- and long-term plans that reflect economic necessity and humane consideration for the victims of these abuses must be developed through faculty governance and collective bargaining processes.

NEA recommends, therefore, that: each institution should immediately begin to develop a handbook of policies on part-time and temporary faculty employment that incorporates the principles set forth in NEA policy statements.

Each institution should begin to allocate the funds necessary to convert improper part-time positions.[26] As soon as possible, the compensation of all part-timers should be prorated.

NEA state affiliates should encourage and support the conversion of part-time positions to full-time positions among public (and private) institutions. In most instances this will require increased regular or supplemental appropriations by state legislatures. If after a reasonable period of time colleges and universities continue the misuse and abuse of these types of appointments, NEA state affiliates should work with faculty organizations to develop appropriate legislative remedies.

On the basis of longstanding policy and the principles and recommendations specified above, NEA strongly urges that steps be taken immediately to eliminate the misuse and abuse of part-time, temporary, and nontenure track appointments. Dramatic action is necessary in this area, as it is elsewhere, to restore excellence and equity in American higher education for this and future generations of students, teachers, and scholars.

NOTES

1. P. Brinkman and J. Krakower, *Comparative Data for Administration in Higher Education*, (Boulder, CO: National Center for Higher Education Management Systems, 1983).

2. Mitchell H. Raibom, *Revenues and Expenses of Intercollegiate Athletic Programs: Analysis of Financial Trends and Relationships*, (Mission, KA: National Collegiate Athletic Association), p. 49.

3. "Recommended Institutional Regulations on Academic Freedom and Tenure," 1982. These are endorsed by NEA.

4. Donald C. Cell, "Opening Question-Raising Remarks: Tenure and Exigency Problems," paper presented at AAUP Conference on Hard Times, Washington, D.C., May 20, 1982.

5. For a description of a controversial early retirement system developed at Michigan State University, see Mordechai E. Kreinin, "Preserving Tenure Commitments in Hard Times: The Michigan Experience," *Academe*, Vol. 68, No. 2 (March-April 1982). Another view is presented by Collette Moser, Roy Matthews, and Marvin Grandstaff, "Buyouts at MSU," *Academe*, Vol. 68, No. 5 (September-October 1982).

6. Cited in John A. Gray, "Legal Restraints on Faculty Cutbacks," in *Challenges of Retirement*, James R. Mingle and Associates, (San Francisco: Jossey-Bass, 1981), p. 177.

7. *Ibid.*, p. 188.

8. *Ibid.*, p. 187.

9. James R. Mingle, "Redirecting Higher Education in a Time of Budget Reduction," *Issues in Higher Education*, No. 18 (Atlanta: Southern Regional Education Board, 1982).

NOTE: Footnotes 10 through 26 are the original footnotes for the NEA Report and Recommendations published here as Appendix B.

10. Ernest L. Boyer, *College: The Undergraduate Experience in America*, (New York: Harper and Row, 1987), pp. 136-137, and Howard R. Bowen and Jack H. Schuster, *American Professors: A National Resource Imperiled*, (New York: Oxford Press, 1986), pp. 60-65. The latter authors estimate that the number of part-time faculty increased from 82,000 in 1960 to 220,000 in 1980. Studies of part-time faculty in specific states and types of institutions are relatively numerous. Neither the standing Committee nor the NEA's higher education staff reviewed all of this literature or research. Although several key studies and reports were considered, the Committee's observations and conclusions are based largely on the individual members' experiences at their institutions, which range from large research universities to small community colleges. Other works that the Committee found useful and recommends to readers include:
David Leslie, Samuel E. Kellams, and G. Manny Gunne, *Part-time Faculty in American Higher Education*, (New York: Praeger, 1982).
Howard P. Tuckman, Jaime Caldwell, and William Vogler, "Part-Timers and the Academic Labor Market of the Eighties," *American Sociologist*, November 1978, pp. 88-104.
M. Elizabeth Wallace (ed.), *Part-time Academic Employment in the Humanities*, (New York: Modern Language Association, 1984).
The Committee also reviewed George E. Biles and Howard P. Tuckman, *Part-time Faculty Personnel Management Policies*, (New York: American Council on Education/Macmillan, 1986).
A bibliography is available in *Thought & Action: The NEA Higher Education Journal*, Spring 1987, pp. 59-62.

11. "Misuse of Part-time Faculty," Resolution E-16, *NEA Handbook* 1986-87, p. 231.

12. "Statement on Academic and Intellectual Freedom and Tenure," *The NEA Higher Education Advocate*, January 30, 1987, p. 3.

13. "Statement on Professional Compensation and the Finances of Higher Education," *The NEA Higher Education Advocate*, January 30, 1987, pp. 6-7.

14. Howard P. Tuckman, William D. Vogler, and Jaime Caldwell, *Part-time Faculty Series* (Washington AAUP, 1977-78), established six categories of part-timers: retired persons, graduate students, "hopefuls," "moon-

lighters," " homeworkers," and "outsiders."

15. This report estimates that 25% of all faculty in four-year colleges and universities are part-timers, and recommends that this be reduced to 20%. Boyer, p. 137.

16. The Standing Committee reviewed closely "The Status of Part-time Faculty," a 1980 report by a subcommittee of Committee A of the American Association of University Professors. *AAUP Policy Documents and Reports* (1984), pp. 47-57. It should be noted, however, that this report and its recommendations were not endorsed or adopted by Committee A, the AAUP Council or Annual Meeting. For a statement of academic due process in non-collective bargaining situations, readers should refer to the "1982 Recommended Institutional Regulations on Academic Freedom and Tenure," which are also found in this publication, pp. 21-30.

17. See the NEA's 1986 "Statement on Academic and Intellectual Freedom" cited above.

18. Bowen and Schuster, pp. 64, 144. Also, "1986 Survey of NEA Higher Education Members," typescript (NEA Research, 1987). More than half of NEA members believe that tenure quotas, temporary contracts, and "rolling" contracts inhibit academic freedom on their campuses, but only 10% believe that there are too many part-timers on staff.

19. The NEA developed a handbook to guide faculty representatives at collective bargaining and non-collective bargaining institutions in drafting policy manuals for part-time and temporary faculty appointments. For more information contact the NEA Office of Higher Education, Suite 410, 1201 16th Street, NW, Washington, D.C. 20036.

20. As noted in the body of this report, the Standing Committee believes that there are legitimate uses of regular and irregular part-time faculty. The Committee tends to agree with Bowen and Schuster (p. 190-191) that part-timers in substantial numbers will always be found in higher education. However, a return to the number of part-timers in 1970 seems a reasonable goal—a process that Bowen and Schuster estimate would produce 28,000 jobs for regular, full-time faculty.

21. At this point, the Standing Committee does not have enough data on the number of nontenure track faculty. Some data has been published by AAUP in its "Annual Report on the Economic Status of the Profession." *Academe The Bulletin of AAUP* March-April, 1987. AAUP estimates that approximately 10% of teaching faculty are in non-tenurable positions, see Scott Heller, "Faculty Pay Up 5.9 Pct. to $35,470; Best Rise in 15 Years, AAUP Says." *The Chronicle of Higher Education* April 8, 1987, pp. 1, 16.

22. Scott Heller, "Part-time Teachers Turn to Unions to Alter Status as Academic Stepchildren." *The Chronicle of Higher Education*, January 28, 1987, p. 1.

23. See, for example, the Massachusetts Society of Professors/Faculty Staff Union collective bargaining contract (1983-86) covering full-time and regular part-time faculty at the University of Massachusetts, pp. 59-62. Many NEA collective bargaining units in community colleges also include part-timers. For other examples see the *Chronicle of Higher Education* article cited above. However, other studies condude that part-timers have not been well served by inclusion in full-timer units, see David Leslie's work cited above, pp. 59-66.

24. Bowen and Schuster, p. 244.

25. *College: The Undergraduate Experience in America, and Professors: A National Resource Imperiled* are excellent examples of this, although they offer good data, analysis, and insights into the problems confronting higher education. Education reform sounds good, but it tends to lose momentum when legislators begin the funding process, see *Education Daily*, April 14, 1987, pp. 1-3, for insight into what is necessary to sustain reform at least in the public schools.

26. The Standing Committee does not underestimate the expense or time involved in making these conversions, given the extent of the problem and the limited funds available. What must occur first, of course, is the making of a commitment by the institution—faculty administration, and board—to this course of action. Once the commitment has been made, the administration and faculty can cooperate in developing new policies and seeking the additional funding that will be necessary.

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National Education Association
Office of Higher Education
1201 Sixteenth Street N.W.
Washington D.C. 20036